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# *The* December Accounting Review

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The Law of Goodwill.....*Gabriel A. D. Preinreich*

Classification and Terminology of Individual Balance-Sheet Items..  
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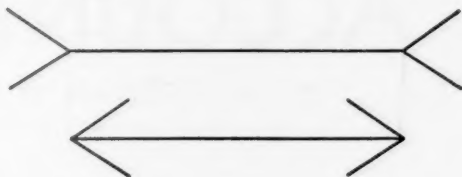


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# The Accounting Review

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## THE LAW OF GOODWILL

GABRIEL A. D. PREINREICH

THE BASIC LEVELS of thought which have guided jurists in their formulation of the legal concept of goodwill are the same as those along which economic analysis has developed. According to the exigencies of the cases before them, the courts have paid attention in turn to consumer-psychology, to the factors which produce goodwill, and to the value which may be placed upon it in terms of money, as well as to the safeguarding of the benefits conferred by goodwill in order to permit its peaceful possession and transfer.

Attempts to define goodwill and list its principal characteristics disclosed, first of all, that it has no independent existence of its own. Early opinions, therefore, are concerned more with what goodwill attaches to than with what it consists of. It originally appeared in the form of the rental value of land and its earliest known mention occurs in conjunction with land in 1571 (Wills & Ind. N.C. Surtees 1835, p. 352): "I gyve to John Stephen . . . my whole interest and good will of my Quarrel" (i.e. quarry).<sup>1</sup>

### LOCAL GOODWILL

The oldest known decision on goodwill is said to be *Broad v. Jollyfe*, 1620 (Cro. Jac. 596; Noy 98). It concerns the validity of a promise by a mercer not to keep shop in Newport, in the Isle of Wight, in consideration of the plaintiff's purchasing his stock at prime cost. The court held the promise to be good, remarking that "it is but the selling of his custom and leaving another to gain it."

<sup>1</sup> Cf. P. D. Leake: *Commercial Goodwill*, Sir Isaac Pitman & Sons, Ltd., London, 1921.

Far better known is the case of *Crutwell v. Lye*, 1810 (17 Ves. Jr. 335), in which the sale of the goodwill of a country waggoner was in litigation, causing Lord Chancellor Eldon to formulate his famous definition that goodwill "is nothing more than the probability that the old customers will return to the old place." Lord Langdale expressed the same view, when he said in *England v. Downs*, 1842 (6 Beav. 269): "It is the chance or probability that custom will be had at a certain place of business, in consequence of the way in which that business has been carried on." And in *Austen v. Boys*, 1858 (27 L.J.Ch. 714), it was held that, "When a trade is established in a particular place, the goodwill of that trade means nothing more than the sum of money any person would be willing to give for the chance of being able to keep the trade connected with the place where it has been carried on."

The basic idea was put forward even more bluntly in *Comm. of Inland Rev. v. Glasgow, etc. Railway*, 1867 (L.R. 12 A.C. 315): "... in strictness, the thing which is to be ascertained is the price of the land." However, "if by reason of the rise in the value of property in the neighbourhood the saleable value of the business has increased, that is a favorable chance which has befallen the tenant" of a public house who was entitled by agreement to receive, upon termination of his lease, a sum equalling the value of the goodwill (*Levellyn v. Rutherford*, L.R. 10. C.P. 456-7). In *Musselman and Clarkson's Appeal*, 1869 (62 Pa.St. 81) the court held that goodwill "attaches to and enhances the value of reality and the value

of it is realized in renting or selling that." And it is affirmed in *Elliott's Appeal* (62 Pa. St. 161) that goodwill is purely local in character and tends to pass with the land to the purchaser or lessee. Among other cases may be mentioned *Rawson v. Pratt*, 1883 (91 Ind. 9), which practically repeats the statements made in *Austen v. Boys* above, and *Cottrell v. Babcock Printing Press Mfg. Co.*, 1886 (54 Conn. 122), where goodwill was found confined to a particular stand. The case of *George v. Coal Co.* (83 Tenn. 458) refers to a monopoly of location through exclusive contracts for the establishment of company stores in lumbering and mining camps.

Attempts at more formal definitions of goodwill are made in *Metropolitan Bank v. St. Louis Dispatch Co.* (36 Fed. 722): "It is intangible property which, in the nature of things, can have no existence apart from a business of some sort that has been established and carried on at a particular place." Also in *Vonderbank v. Smith* (44 La. Ann. 276): "Goodwill is the favor which the management of a business wins from the public and the probability that all customers will continue their patronage. It is the general public patronage and encouragement which a business receives from its customers on account of its local position; that is the subject of value and price and of bargain and sale, though intangible." In this definition the patronage concept is dominant, although its dependence upon location is still mentioned.

#### PATRONAGE AND TRADE CONNECTION

In general it may be said that the emphasis upon the local aspect of goodwill has declined gradually, although there has been considerable overlapping of views in point of time. It appears that a decision rendered as early as 1743 uses the land concept only by way of analogy. The children of a deceased newspaper printer and publisher demanded their share of the business from his widow and executrix and the claim was allowed by Lord Hardwicke, who said: "Suppose the house were a house of great trade, she must account for the goodwill of

it" (*Giblett v. Reade*, 9 Mod. 459). It is not clear whether the premises were owned by the estate or not. In 1817 it was likewise decided that "the very circumstance of sole ownership gives . . . an advantage beyond the actual value of the property and which may be pointed out as a distinct benefit essentially connected with sole ownership", rather than with location alone (*Kenney v. Lee*, 3 Mer. 441).

Almost sixty years later, Sir John Romilly, Master of the Rolls, cautiously decided that goodwill "seems to be that species of connection in trade, which induces customers to deal with a particular firm" (*Wedderburn v. Wedderburn*, 1855. 22 Beav. 84). The case of *Crawshay v. Collins* (15 Ves. Jr. 224) affirms that this connection consists of the disposition, confidence and faith of customers. And "it is the formation of the connection which has made the value of the thing which the late firm sold and they really had nothing else to sell in the shape of goodwill. Is it to be supposed that they did not sell that personal connection when they sold the trade or business and the goodwill thereof?" (*Ginesi v. Cooper*, 1880. L.R. 14. Ch. Div. 600). In the leading case of *Trego v. Hunt*, 1886 (A.C. 7; 12 T.L. 80) Lord Macnaghten defined goodwill as "the whole advantage, whatever it may be, of the reputation and connection of the firm, which may have been built up by years of honest work, or gained by the lavish expenditure of money." The facts upon which this definition is based were that Trego took Hunt into partnership with the understanding that the latter would not thereby obtain any interest in the goodwill of the firm. Upon Trego's death, his widow commissioned Hunt to carry on for seven years. When this term drew to a close, Hunt employed a clerk to copy the names and addresses of all customers. Held, that Hunt may properly be restrained from "either personally or through his partners, servants or agents, applying privately, by letter or personally or by a traveller, to any person who was prior to the date of the sale a customer of the old firm, asking such customer to continue after the sale to deal with him and not to deal with the purchaser" who

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had acquired the goodwill from the widow.

A number of comparatively recent American decisions contain definitions of goodwill much in the same vein. For example in *Rowell v. Rowell*, 1904 (122 Wis. 1) it is called "a beaten pathway from the seller to the buyer" and in *Dodge Stationery Co. v. Dodge*, 1904 (101 Wash. 383) "a well-founded expectation of public patronage." In *Chittenden v. Whitbeck* (50 Mich. 401) the point is emphasized that "the favor which the management has won from the public and the probability that the old customers will continue their patronage" is not transferred by a mere sale of the premises, because trust, confidence and esteem may be attached to some other material object.

#### GOODWILL ATTACHED TO STOCK-IN-TRADE

The goodwill of a vendor of victuals was held to be an incident of the stock and license, but not of the premises in *Geo. Fox Co. v. Glynn*, 1906 (191 Mass. 349) and in the two earlier cases of *Cruess v. Fessler*, 1870 (39 Cal. 336) and *Herford v. Cramer*, 1884 (7 Col. 485). The last two decisions overruled the defendants' claims that they had not sold the goodwill because the stock alone was worth the full amount paid by the purchasers.

#### COMPREHENSIVE DEFINITIONS OF GOODWILL

The firm name as an element of goodwill is first mentioned in *Churton v. Douglas*, 1859 (1 Johnson 174), when Vice Chancellor Wood gave the following definition:

Goodwill must mean every advantage that has been acquired by the old firm, whether connected with the premises in which the business was previously carried on, or with the name of the firm, or with any other matter carrying with it the benefit of the business.

Lord Lindley in *Comm. of Inland Rev. v. Muller & Co.'s Margarine*, 1901 (A.C. 217) was still more explicit:

Goodwill regarded as property has no meaning, except in connection with some trade, business or calling. In that connection I understand the word

to include whatever adds value to a business by reason of situation, name, reputation, connection, introduction to old customers and agreed absence from competition or any of these things, and there may be others which do not occur to me.

Judge Story's definition is also frequently quoted:

The advantage or benefit which is acquired by an establishment beyond the mere value of the capital, stock, funds or property employed therein in consequence of the general public patronage and encouragement which it receives from constant or habitual customers on account of its local position, or common celebrity, or reputation for skill, or affluence, or punctuality, or from other accidental circumstances or necessities, or even from partialities or prejudices.<sup>2</sup>

The foregoing definitions show that there are many forms of goodwill besides that which is attributable to a definite location. Nevertheless, all these forms originally arose from personal efforts or qualities and now differ only to the extent to which it is possible to separate them from persons and attach them to a tangible object or visible sign which may be transferred. The study of goodwill, in this sense, is a study of the ways and means of making it transferable.

#### PERSONAL GOODWILL

Purely personal goodwill has often been denied recognition merely because it was thought to be entirely untransferable. Thus it was held in *Austen v. Boys*<sup>3</sup> that "the term goodwill seems wholly inapplicable to the business of a solicitor." Similarly in *Bain v. Munro* (5 Rettie 422): "... in a business of a professional nature the goodwill is of so intangible a nature as to be impossible of transference and not of appreciable value." And in an American case: "The practice of a physician is a thing so purely personal, depending so absolutely on his personal skill and ability, that when he ceases to exist it necessarily ceases also, and after his death can have neither an intrinsic nor a market value" (*Mandeville v. Harman*, 1886. 42 N.J. Eq. 185).

<sup>2</sup> *Story on Partnerships*, §99.

<sup>3</sup> *Supra*, p. 317.

That portion of professional goodwill which is transferable has been defined by Sir George Jessel in *May v. Thompson*, 1882 (L.R. 20. Ch.D. 705): "What is the meaning of selling a medical practice? It is the selling of the introduction of the patients of the doctor who sells to the doctor who buys. He has nothing to sell except the introduction." In an earlier case such an introduction was mentioned as constituting goodwill when accompanied by a vendor's covenant not to compete with the vendee: "... very frequently the goodwill of a business or profession, without any interest in land connected with it is made the subject of the sale, though there is nothing tangible in it; it is merely advantage of the recommendation of the vendor to his connections and his agreeing to abstain from all competition with the vendee" (*Potter v. Commissioner*, 1854. 10 Exch. Rep. 146). That even a posthumous introduction may be valuable was held in *Thomson v. Winnebago County*, 1878 (48 Iowa 155), where a list of names and addresses found among the records of a deceased land agent was ordered sold as an asset of his estate. Similarly the goodwill of a deceased dentist became a part of his estate in *Morgan v. Schuyler* (79 N.Y. 490).

"The goodwill of a commission merchant, originating with himself and carried on without capital for fifteen or twenty years, would seem rather to resemble that of a doctor or lawyer than that of a retail merchant" (*Kremelberg v. Thompson*, 87 N.J. Eq. 659). But in *Davie v. Hodgson* (25 Beav. 181) the goodwill of a commission merchant was declared valuable only if the vendor agreed not to carry on the same business.

Even before the limited transferability of personal goodwill was generally recognized, some attention was given to its special characteristics in English and Scottish land tax cases. For instance, in *Assessor for Lanark v. Selkirk* (14 Rettie 579) the court ruled that to the extent to which goodwill was of a personal nature, it could not be included in the rates assessed. Another English decision concerning personal goodwill is *Cooper v. Metropolitan Board of Works*, 1883 (25

Ch.D. 472), which held that if goodwill depends on the skill of the seller, it is not transferred merely through the sale of the premises. An American case to the same effect is *Smith v. Gibbs*, 1862 (44 N.H. 335), holding that the sale of a business with its goodwill "does not include the popularity and personal qualities of the seller, which are not transferable."

#### VENDORS' COVENANTS

A promise by the seller that he will not compete with the purchaser derives its importance from the fact that most forms of goodwill are to a certain extent both local and personal. A number of cases already cited refer to vendors' covenants, among them characteristically enough the oldest case on record, i.e. *Broad v. Jollyfe*.<sup>4</sup> Another early decision holding such a promise valid is *Mitchell v. Reynolds*, 1711 (1 P. Williams 181; I.S.L.C., 9th Ed., p. 430). In this case the plaintiff had taken over the defendant's lease for five years of a bake house in the parish of St. Andrews, Holborn, the defendant binding himself not to exercise the trade of baker within that parish during that term.

Where it is evident that goodwill is nothing but a personal connection established in a local area, it has been held that the vendor's covenant is the only valuable consideration involved in the sale, regardless of whether or not it has been expressly mentioned. A Massachusetts case in point is *Angier v. Webber*, 1867 (14 Allen 211), forbidding the seller of a teamster's route to solicit custom along it, even though it was not claimed that the defendant had agreed to refrain from competition. Other decisions which protect the purchasers of newspaper or milk routes against the sellers are *Senter v. Davis*, 1869 (38 Cal. 450), *Tuttle v. Hannegan*, 1874 (54 N.Y. 686), *Munsey v. Butterfield*, 1882 (133 Mass. 492) and *Wenzel v. Barbin*, 1899 (189 Pa. St. 502).

On the other hand, there are cases on record which permit competition by the seller. In *Cottrell v. Babcock Printing Press*

<sup>4</sup> *Supra*, p. 317.

*Mfg. Co.*<sup>5</sup> the decision that goodwill was confined to a particular news stand resulted in judgment for the defendant, who was allowed to compete and did in fact maintain his stand in the immediate vicinity. With respect to the trade of a Boston department store it was held in *Basset v. Percival*, 1862 (5 Allen 345) that the custom or trade appertained strictly to the place of business, which was surrounded by an area containing further inchoate patronage and potential goodwill separate from that already adhering to the store. The seller was, therefore, restrained from soliciting his old customers, but permitted to set up another establishment near the first to compete for the potential custom which might still be attracted.

*Crutwell v. Lye*,<sup>6</sup> made famous by Lord Eldon's definition of goodwill, also belongs in this category except for the fact that the goodwill was sold, not by the owner, but by his trustees in bankruptcy. It was therefore held that a bankrupt has no obligation to refrain from reengaging in the same business subsequent to his discharge. This privilege of a bankrupt is still recognized.

The case of *Myott v. Greer* (90 N.E. Rep. 895) is of interest because it concerns the assignment of the rights enjoyed under a vendor's covenant, which provided that the seller may not compete for ten years within a radius of twenty miles. The plaintiff organized a corporation, then dissolved it, and resumed the business individually under the original name of the defendant, who had in the meantime likewise reengaged in business in the same town. The complaint was rejected on the ground that a resolution of the company's board of directors reassigning the goodwill and covenant to the plaintiff was not binding upon the defendant and insufficient to give the plaintiff the right to maintain suit.

The general principles governing restraint of trade by voluntary agreement were laid down as early as 1711 in *Mitchell v. Reynolds*.<sup>7</sup> Freedom of contract demands that such agreements be set aside as rarely as

possible because the owner of a business possesses the legal right to his custom and goodwill and may part with it under certain conditions. Contracts in partial restraint of trade are, therefore, beneficial to the community, so long as the terms are reasonable, but limitations as to time and place are generally held essential. Unlimited restraint is contrary to public policy, not only because it tends to deprive the seller of his livelihood and the state of the services of a useful citizen, but also because it tends to centralize control over industry and to create monopolies.<sup>8</sup>

#### FIRM AND TRADE NAMES

The name is a means of identifying the business to which goodwill attaches, and as such it is entitled to protection against unauthorized use. This principle is outlined in *Levy v. Walker*, 1879 (10 Ch.D. 436):

A man has the right to say: "You must not use a name, whether fictitious or real; you must not use a description, whether true or not, which is intended to represent, or calculated to represent to the world that your business is my business, and so by fraudulent misstatement deprive me of the profits of the business which would otherwise have come to me." That is the principle, and the sole principle, on which this court interferes.

The firm name was first included in a definition of goodwill by Vice Chancellor Wood.<sup>9</sup> In the United States, federal court decisions consider it an important element:

"The goodwill of a business comprises those advantages which may inure to the purchaser from holding himself out to the public as succeeding to an enterprise, which has been identified in the name and repute of his predecessor" (*Knoedler v. Boussod*, 45 Fed. 465). "... all that good disposition which customers entertain toward the house of business identified by the particular name of the firm, and which induces them to continue giving their custom to it" (*Washburn v. National Wall Paper Co.*, 1897 (81 Fed. 17)).

In *Cooper v. Hood*, 1858 (26 Beav. 293) it was held that the use of the name, the vendor's covenant and the trade mark were all

<sup>5</sup> *Supra*, p. 318.

<sup>6</sup> *Supra*, p. 317.

<sup>7</sup> *Supra*, p. 320.

<sup>8</sup> Cf. C. J. Foreman: *Efficiency and Scarcity Profits*, University of Chicago Press, 1930, pp. 124-26.

<sup>9</sup> *Supra*, p. 319.

included in the goodwill of the enterprise. The sale of a periodical includes the sale of the right to use the old name or title (*Bradbury v. Dickens*, 1859. 27 Beav. 53). But the name of a theatre attaches to and is transferred with the premises (*Booth v. Jarrett*, 1876. 52 How. Pr. 169). In the case of a deceased dentist the court mentioned separately his goodwill and the name of his firm as assets of his estate,<sup>10</sup> while in *Slater v. Slater*, 1903 (175 N.Y. 143) the name was said to be included in goodwill.

With reference to trade names the decision in *Brock v. Paine*, 1912 (28 R.P.C. 697) deserves mention: "The plaintiffs having for nearly fifty years applied the words 'Crystal Palace' to their goods, it was irrelevant to consider whether they had still got the right to give displays at the Crystal Palace. The words did not imply that they had and therefore the plaintiffs are entitled to a perpetual injunction" restraining the defendants from using the same name, even though they had succeeded to the privilege of displaying fireworks there.

In principle, a person can not be prevented from using his own name in business, even though another person having the same name is already established in the same field. Thus in *Brinsmead v. Brinsmead* (29 T.L.R. 706 C.A.) it was held that "there being no evidence of dishonesty, the defendant could not be restrained." The courts will, however, carefully scrutinize the evidence to detect fraudulent intentions. For instance, when the brother of the original manufacturer of preparations known as "Holloway's Pills and Ointments" opened an establishment only a few doors away and not only called his products by the same name, but also used similar pill boxes, pots, labels and wrappers, the petition for an injunction was granted (*Holloway v. Holloway*, 1850. 13 Beav. 209).<sup>11</sup>

The legal protection accorded to firm or trade names is a step toward increasing the transferability of goodwill by attaching it,

not to the person who originated it, but to the organization with which he was originally connected.

The rule is also firmly established that a trade name may not be sold apart from the business which has built up the goodwill adhering to it. *Thorniloe v. Hill*, 1894 (1 Ch. 569) illustrates this rule, the court having held that even if anything was assigned, it was merely the right to use the name John Forrest, London, unconnected with any business. This being a mere assignment in gross, was void.

In the case of *Geo. Fox Co. v. Glynn*<sup>12</sup> the name, as well as certain distinct characteristics of the merchandise, was involved. The decision mentions that "it is important to everyone who has built up a valuable goodwill in that way" (i.e. through advertising its name and through square and honest dealing) "to have it protected as his other property is protected." The plaintiff was a well-known bakery and obtained protection against infringement for the particular kind of bread it produced, the loaves of which were of a definite shape, size and quality.

#### TITLES AND AWARDS

The privilege of displaying coats of arms of the ruler or the princes of royal blood, accompanied by the title: "Purveyor to H. M. the King," etc., is seldom mentioned nowadays as an element of goodwill, although in many countries it is still a distinction in great demand, obtainable only with great difficulty or at great expense. The endorsement of other important personages in the public eye is also valuable on the theory that their goodwill attracts the custom of the rank and file.

Medals and certificates of merit awarded at expositions are often reproduced on labels, and more recently there has been a tendency to obtain the approval of professional associations or bureaus of standards, such as the American Medical Association, the Good Housekeeping Institute, etc. All these forms of goodwill are protected by the courts against unfair practices.

<sup>10</sup> *Morgan v. Schuyler*, *supra*, p. 320.

<sup>11</sup> Cf. also *McLean v. Fleming*, 1877 (96 U. S. Rep. 245), listing over a dozen specific points involved in the protection of trade names and trade marks.

<sup>12</sup> *Supra*, p. 319.

## TRADE MARKS

Interesting excerpts from the history of trade names and trade marks have been assembled by Rogers.<sup>13</sup> The identification of traders and their wares by means of symbols is a practice as old as trade itself. Regulation soon followed, capital punishment being inflicted upon many occasions both for failing to mark goods and for marking them improperly or with fraudulent intent.

The modern law of trade marks has developed from these ancient statutes and thus has an independent origin, since goodwill as a legal concept has not arisen until much later. For this reason trade marks are often considered a separate subject, although they are nothing more than one of the many forms in which personal goodwill manifests itself. The tendency to draw a distinction is apparent in *Peltz v. Eichele*, (62 Mo. 177):

The goodwill of a business, as embodied in the firm name or in the labels used will be protected on principles analogous to those applied in cases of infringements of trade marks. It is true that a trade mark is held by some textbook writers and perhaps in some adjudicated cases, to be a part of the goodwill and necessarily included in the sale thereof.

The principles of protection are outlined in *Ransome v. Graham*, 1882 (51 L.J.Ch. 897):

A manufacturer who produces an article of merchandise which he announces as one of public utility, and who places upon it a mark by which it is distinguished from all other articles of a similar kind, with the intention that it may be known to be of his manufacture, becomes the exclusive owner of that which is henceforth known as his trade mark. The property thus acquired by the manufacturer, like all other property is under the protection of the laws and for the invasion of the right of the owner of such property the law affords a remedy similar in all respects to that by which the possession and enjoyment of all property is secured to the owner.

A shorter summary is given in *Cash v. Cash*, 1902 (19 R.P.C. 181):

An honest man will wish to take all reasonable precautions to prevent his goods being confounded with those of other traders. If man is

not an honest man, then the law will step in and make him behave like one.

The assignment of a "naked" trade mark is just as invalid as that of a trade name apart from the business to which it used to belong. A case in point is *Pinto v. Badman*, 1891 (18 R.P.C. 181), in which it was held that "a trade mark, when registered, shall be assigned and transmitted only in connection with the goodwill of the business concerned in the particular goods or classes of goods for which it has been registered and shall be determinable with that goodwill." And where an outgoing partner claimed the right to use the trade mark, judgment was rendered in favor of the partners remaining with the business because "if a business were sold without any word being said about the trade mark, the trade mark would be understood and held to pass to the purchaser" (*Shipwright v. Clements*, 1871. 19 W.R. 599).

If the surname of one person is the same as the trade mark of another, the question arises, as in the case of a trade name, concerning the extent to which deception is intended or possible. In *re Cadbury*, 1914 (59 S.J. 161) it was decided that "where the name in everybody's mind refers to the goods of one firm, such name is distinctive," which any valid trade mark must be. To avoid such difficulties, trade-mark statutes generally stipulate that descriptive, personal or geographical names may not be registered, except in the form of, or as parts of, fanciful and distinctive devices. Examples are signatures of misspelled descriptive words, etc.<sup>14</sup>

Modern advertising campaigns tend to concentrate increasingly upon trade marks at the expense of firm names. Certain brands have thus become household words, although not many consumers know the names of the respective manufacturers. This tendency further increases the transferability of goodwill by attaching it altogether to the product.

## TRADE SECRETS, PATENTS AND COPYRIGHTS

A trade secret consists of confidential information pertaining to trade, manufacture

<sup>13</sup> E. S. Rogers: *Trade Marks and Unfair Trading*, A. W. Shaw Co., Chicago, 1914.

<sup>14</sup> Cf. note 11, *supra*.

or invention, the exclusive possession of which entails certain advantages of a differential or monopolistic nature. In order to receive protection as valuable goodwill, trade secrets must actually be secret (*Macbeth Evans Glass Co. v. Schnellbach*, 239 Pa. St. 76). An employee is "in equity and good conscience obliged to preserve them as sacredly as his own, and this as well without a contract as with it" (*Simmons Med. Co. v. Simmons*, 81 Fed. Rep. 163), because "the law will imply a promise to keep the employer's secret" (*Westervelt v. National Paper Co.*, 154 Ind. 673).

Such secrets may range all the way from simple lists of customers (*Stevens & Co. v. Stiles*, 29 R.I. 399; A.R. 802), a code key of prices in a sales catalogue (*Simmons Hardware Co. v. Waible*, 1 S.D. 486) or information in the possession of a counting-house clerk (*Tipping v. Clarke*, 2 Hare 393), to a manufacturing process (*Solomon v. Hertz*, 40 N.J. Eq. 400) or to engine drawings (*Merryweather v. Moore*, 61 L.J. Ch. 506). All these cases referred to employees, but the principle of protection operates in other cases as well. Thus in *National Gum & Mica Co. v. Braendly* (51 N.Y. Supp. 93) and in *Bryson v. Whitehead*, 1822 (1 Sim. & Stu. 74) the defendants were enjoined from using secrets sold by them and from thereby depriving the plaintiffs of valuable goodwill which they had purchased.

The law of patents has developed from a desire to give more adequate protection to certain forms of trade secrets and to reserve for a limited time to their originators the benefits derived from them. The foundations of modern patent law were laid when the Statute of Monopolies was promulgated in England in 1623. This statute granted the privilege "of the sole working or making of any manner of new manufactures within this realm, to the true and first inventors of such manufactures, which others at the time of making such letters patent and grants shall not use, so also as they be not contrary to the law or mischievous to the State."

It is universally conceded that a secret or discovery is patentable only if it involves an exercise of the inventive faculties. As to

what is covered by this phrase, the U.S. Supreme Court declared in *McClain v. Ortmayer* (141 U.S. 427) that the word invention "can not be defined in such a manner as to afford any substantial aid" in this respect. "Courts, adopting fixed principles as a guide, have by a process of exclusion determined that certain variations in old devices do or do not involve invention, but whether the variation relied upon in a particular case is anything more than ordinary mechanical skill is a question which cannot be answered by applying the test of any general definition."

There are innumerable decisions in which this negative method of definition by exclusion has been followed in order to narrow down gradually the concept of a patentable invention. Thus it has been held that an application for a patent must be based upon something more than that which any efficient mechanic could easily produce (*Vinton v. Hamilton*, 104 U.S. 491). Nor is it enough that an improvement is new and has great economic advantages (*Hild v. Wooster*, 132 U.S. 700). Duplicating the parts of a machine is no invention, unless it causes a new mode of operation (*Dunbar v. Meyers*, 94 U.S. 197), nor can a mere assembly (*Reckendorfer v. Faber*, 92 U.S. 357) or a combination of old devices (*Hall v. MacNeale*, 107 U.S. 90) be so classified. It is often reiterated that the patent law applies only to subjects which contribute definitely to the useful arts (*Atlantic Works v. Brady*, 107 U.S. 199) and which are a product of the inventive powers (*Magin v. Karle*, 150 U.S. 391).

With respect to the ownership of a patentable invention, it has been said that mere suggestions or assistance from others will not give them a right to share in the benefits (*Pitt v. Hall*, 2 Blach. 229). Where a partner used all the facilities of his firm to devise improvements in the product manufactured by it, his patented inventions did not become the property of the partnership (*Belcher v. Whittemore*, 134 Mass. 330). Similarly in the case of employees, the courts have protected their personal rights to their own inventions, although developed at the

expense of employers (*Barber v. National Carbon Co.*, 129 Fed. Rep. 370). In such circumstances, however, the partner or employee must usually grant a shop license to his firm, permitting the use of the invention without payment of a royalty. But this license need not be exclusive (same cases; also *Slemmer's Appeal*, 58 Pa. St. 156, *McChurg v. Kingsland*, 1 How. 202, and others), nor is it transferable upon dissolution of the corporation (*Peabody v. Norfolk*, 98 Mass. 40). There are also several cases in which it was held that the employer is entitled merely to the reasonable value of the assistance rendered in making the models and experiments, including the value of the employee's time (*Collar Co. v. Van Dusen*, 23 Wall. 563).

An employer may acquire a right to the inventions of his employees, if he engages them specifically as inventors. This condition must be clearly expressed in the contract of employment (*Hildreth v. Duff*, 143 Fed. Rep. 139).

If a patent is infringed upon through unauthorized use, the rightful owner may maintain an action for damages. The measure of his damages is the gain which the infringer has derived. This gain the claimant has the right to recover (*Mowry v. Whitney*, 14 Wall. 642 and others). The gain need not consist of a net profit; a smaller loss than would otherwise have resulted also reflects a gain from the use of the patent (*Mews v. Conover*, 125 U.S. 144, and *Celluloid Mfg. Co. v. Cellonite Mfg. Co.*, 40 Fed. Rep. 478).

A copyright is the exclusive right to reproduce, publish, and sell literary or artistic work. In this respect it is similar to a patent, except that the latter must be disclosed and belongs to the first person who does so in good faith, whereas an author's property in his work is not similarly restricted. To emphasize the difference, it is often said that if Milton had not written "Paradise Lost," no one else could have; but if Newcomen had not invented the steam engine, the same thought would have occurred to others, as in fact, it did.

The term for which patents are now granted in the United States is seventeen years, whereas copyrights are valid for

twenty-eight years and may be renewed for a like period.

#### FRANCHISES AND GOING VALUE

A franchise expresses the goodwill of the commonwealth toward certain of its members, to whom it has granted certain privileges for their own and the public good. The most common form of franchise is that obtained by a company upon incorporation.

"Organization expense" is the name usually given to the cost of acquiring the franchise as well as to other outlays necessary in embarking upon an undertaking and in bringing about the decision to do so. All such expenditures are made only if it is reasonable to expect that avenues of profit will thereby be opened which would otherwise remain inaccessible.

The franchise of a public utility is the privilege of using public property in a business which could not be carried on without that privilege. "Going value" and "going concern value" are terms used in competitive business as well as in the public utility field in various senses. Usually, however, they are meant to represent the difference between the market or saleable value of an enterprise and its depreciated original cost or its reproduction cost. But whereas in the competitive field the essential similarity between goodwill and going value is not denied, it has been held that, in the case of a public utility, going value and franchise can not represent goodwill because "a monopoly has no goodwill, for its customers are retained by compulsion, not by their voluntary choice" (*Bristol v. Bristol Water Works*, 23 R.I. 278). To the same effect is the U. S. Supreme Court decision in *Wilcox v. Consol. Gas. Co.* (212 U.S. 19; 29 Sup. Ct. 192) and *Des Moines Gas. Co. v. Des Moines* (238 U.S. 113).

That a public utility has no goodwill may be true in the psychological sense, but it certainly is not true from the standpoint of value analysis. In order to secure the required flow of funds into the public utility field, it is necessary to set the regulated or allowable rate of return at a level higher than the normal return prevailing in the

open money market. The difference creates goodwill. Franchise, going value and goodwill value are one and the same thing and can be explained only in terms of this excess return, which is perfectly legitimate so long as it is not further enhanced by chicanery and misrepresentation.

Franchise values were held admissible in tax cases, purchase and sale transactions and condemnation proceedings, but not for the purpose of rate valuations in *Spring Valley Water Co. v. San Francisco* (165 Fed. Rep. 666) and in *Monongahela Navigation Co. v. United States* (148 U. S. 312). And that is really the crux of the problem of public utility regulation:

Earnings are dependent upon the rates exacted and hence the higher the rates, the more valuable the franchise and *vice versa*. Obviously, therefore, it would be futile to attempt to determine the reasonableness of a rate by any standard which is at all dependent upon franchise values for its dimensions. The concession that a franchise has value and is the subject of property rights does not at all militate against this principle (*Appleton v. Appleton Water Works Co.*, 5 Wisconsin R.C.R. 215).

The value of the use, as measured by the return, can not be made the criterion when the return itself is in question. If the return as formerly allowed be taken as a basis, then the validity of the State's reduction would have to be tested by the very rates which the State denounces as exorbitant. And if the return as permitted under the new rates be taken, the State's action itself reduces the amount of value upon which the fairness of the return is to be computed (*Fuhrman v. Cataract Power & Conduit Co.*, 3. N.Y.P.-S.C., 2nd Dist. 656, and *Second Minnesota Rate Cases*, 290 U.S. 352; 33 Sup. Ct. 729 to the same effect).

A return can be expected only from investment and he that invests must part with something in the act of investing. The investment in property was made, not in the franchise, but under the franchise and on the faith thereof. The franchise is but a part of the power of sovereignty allotted to a private person for the benefit of all (*Consol. Gas Co. v. City of New York*, 157 Fed. 872).

In other words, the gift of the people should not be capitalized against the people.<sup>15</sup> "It is only when the theory and

purpose of valuation are completely lost sight of, that going values thus considered can have any place in the appraisal for rate-making purposes. Such value adds nothing to the worth of the service and is no part of its cost."<sup>16</sup>

Nevertheless, there are many instances where going values have been accepted by the courts for rate-making purposes. In *National Water Works v. Kansas City* (62 Fed. 853) it was held that "the fact that it is a system in operation, not only with a capacity to supply the city, but actually supplying many buildings in the city—not only with the capacity to earn, but actually earning—makes it true that 'the fair and equitable value' is something in excess of the cost of reproduction." This theory, which makes going value a mere attribute of operation, has been dubbed the "barnacle theory."<sup>17</sup> The conclusion in *Omaha v. Omaha Water Co.* (21 U. S. 180) was to the effect that "going value shall be included in the valuation, if it actually exists," and in *Pillsbury v. Peoples Gas & Light Co.* (4 N.H.P.U.C. 391) the court stated that the property must be valued as a going concern.

Demand has also been made for the recognition of going value for rate-making purposes in the form of the excess of the market value of the plant above its appraised present value. Even if this theory is rejected, as in *Fuhrman v. Cataract*,<sup>18</sup> it is possible to include sums not represented by actual investment in the appraisal value. Goodwill values are sometimes claimed for efficiency of management, competency of supervision and other economies, which really means that, in the opinion of such claimants, rates ought to be based upon the incompetence displayed by some imaginary marginal producer. Recourse has even been had to the classic formula of the probability that customers will continue to come to the same company for service and attempts have ac-

<sup>15</sup> H. Floy: *Valuation of Public Utility Properties*, McGraw-Hill Co., New York, 1912, p. 132.

<sup>16</sup> H. Hartman: *Fair Values*, Houghton Mifflin Co., Boston, 1920, p. 182.

<sup>17</sup> *Ibid.*, p. 177.

<sup>18</sup> *Supra*, p. 326.

cordingly been made to value goodwill at so much per customer.

The so-called Wisconsin rule, which holds that going values in the form of deficits are costs properly capitalized on the same basis as other developmental expenses, has a limited validity in the sense that early losses, or in fact any deficiency below the allowable rate of return, ought to be set up as an item recoverable from future profits earned in excess of that rate. That does not justify permanent capitalization, however. A refinement of the Wisconsin rule is the "comparative plant method," which measures going value by pretending to construct an imaginary new plant with estimated developmental expenses and initial patronage. Development loss is then computed by finding the present value of the excess revenue of the actual plant over and above that of the imaginary one for an estimated initial period. This is one of the ways in which public utilities conform to the judicial dictum that "the burden of substantiating development losses rests on the utility."<sup>19</sup>

The capitalization of various forms of developmental expenses has been the subject of many decisions. Promoters' expenses may be so included upon showing their reasonable necessity and a resulting benefit of the service (*Edwards v. Glen Telephone Co.*, N.Y. 2nd Dist. P.U.R. 1916-B-940), but not if the holding company did the financing (*Herman v. Newton Gas. Co.*, N.Y. 1st Dist. P.U.R. 1916-D-825). Interest during the construction period was allowed in a reasonable amount of *Petalunia & S.R.R. Co.* (Cal. P.U.R. 1915-C-742). Bond discount is not usually recognized as invested capital, since in that case low interest-bearing bonds could be issued to make the amount as large as possible and then let it earn permanently the allowable rate in place of the mere market rate of interest.

With respect to goodwill, franchise, or going values in the case of sale, it is worth mentioning that their recognition in such an event will also lead to exploitation of the consumer. Nevertheless, the New York State

Public Service Commission was recently held to have exceeded its powers when it ordered that property be stated at original cost, i.e., cost at the time it was first devoted to public service, either by the accounting company or a prior owner. The Commission's orders were characterized as "more than general administrative or legislative rules," which "directly interfered with the private property rights of these respondents" (*New York Edison Co. et al. v. Maltbie et al.*, 1935. 279 N.Y.S. 949; 244 App. Div. 436).

#### THE VALUATION OF GOODWILL

Returning to the goodwill of unregulated enterprises, a few decisions concerning the value of goodwill may be reviewed. It was stated in *Austen v. Boys*,<sup>20</sup> 1859, that goodwill meant nothing more than the sum of money which the purchaser would be willing to give. If a business is such that when properly managed it will not yield enough to pay debts, it is not a desirable business, and its goodwill cannot be considered of any value to a prospective purchaser (*Halverston v. Walker*, 1910. 38 Utah 264) because goodwill is the chance of expectancy of securing a future profit (*In re Borden's Estate*, 159 N.Y. Supp. 346).

Conforming to this somewhat too broad concept, the practice of valuing goodwill in terms of annual profits arose. Thus in *Featherstonhaugh v. Turner* (25 Beav. 392) the goodwill of a successful surgeon was valued at two years' net profits. In *Millersh v. Keen* (28 Beav. 453) and *Page v. Ratcliffe* (75 L.T. Rep. 371) valuations of one year and three years, respectively, were approved.

An important American case was *Washburn v. National Wall Paper Co.*, 1897 (81 Fed. 20), in which the court rejected the plaintiff's claim that sixteen times the profit for the eleven months ended May 31, 1892 was an excessive amount to pay. The goodwill of *Hearn's Estate*, 1917 (182 N.Y. 263) was appraised at five times the average profit of the six years preceding the death of the founder of Hearn's Department Store, while

<sup>19</sup> *Pillsbury v. Peoples Gas & Light Co.*, *supra*, p. 326.

<sup>20</sup> *Supra*, p. 317.

Temple Bowdoin's share of the goodwill of J. P. Morgan & Co. (1914) was valued at three times the average of the last ten years.<sup>21</sup> Other examples are *Matter of Silkman*, 1907 (105 N.Y.S. 872) and *Matter of Rosenberg*, 1908 (114 N.Y.S. 726), in each of which two years' profits were held the proper price of goodwill.

*Von Au v. Magenheimer* (110 N.Y.S. 629; 126 App. Div. 257) is considered a leading case because it explains the method of valuation which has been followed for a long time. According to the court there is no specific rule for determining the value of goodwill, but each case must be considered in the light of the surrounding facts. The question of value must be left to the jury, whose conclusions must rest on legitimate evidence establishing that value. The value of goodwill of a manufacturing company may be fairly arrived at by multiplying the past average net profits of a company by a number of years, such number being suitable and proper, having reference to the value and character of the business. But, when feasible, it is also proper to use the results of years subsequent to the sale and conclude therefrom with respect to the conditions prevailing at the time of the sale. The specific ruling in this case was that the goodwill in question was worth five times the average annual net earnings.

With respect to the years which ought to be averaged to obtain a representative annual net profit, it was decided in *re Welch*, 1912 (137 N.Y.S. 941) that "abnormal profits in one of the last three years should be disregarded." The averaging of the last three years has for a time been regarded as the standard method and is so mentioned in *Matter of Moore*, 1910 (69 N.Y. Misc. Rep. 535), although Surrogate Fowler in *Matter of Halle*, 1918 (170 N.Y.S. 898) insists on using an average of four years.

A better grasp of fundamental principles is displayed by the decisions which recognize that the value of goodwill depends, not upon profits, but upon excess profits. An English land tax case (*Reg. v. Grand Junc-*

*tion Rail Co.*, 4 Q.B. 18) prescribes that from the gross profits there are to be deducted the operating expenses, interest on capital invested, a percentage for depreciation of rolling stock and a fair profit for the tenant. The residual surplus approximates the annual rental value of the land, i.e., the goodwill of the landlord, which is the subject of the tax.

The method outlined in *Von Au v. Magenheimer* above has been corrected in *Seach v. Mason-Seaman Transp. Co.*, 1916 (156 N.Y.S. 579) as follows: "In determining the value of the goodwill by multiplying the average net profits by a number of years, such number being suitable and appropriate, the interest on the capital invested should be deducted from the net profits." To the same effect is *Pett v. Spiegel*, 1923 (2 N.Y.S. 650), where the value of goodwill was found by deducting 6% interest on investment from the average net profits of the preceding three years and multiplying the remainder by "the number of years indicated by the facts," i.e., five. The goodwill of the New York jewelry firm of Tiffany & Co. was similarly computed, except that ten years were not considered excessive, in view of the fact that the company had been established for sixty years and had an excellent and wide reputation.<sup>22</sup>

The fair value of the owner's services (\$100,000 p.a.) was deducted in addition to 6% interest on investment in *Matter of Flurschein*, 1919 (176 N.Y.S. 694), to calculate the goodwill of the New York department store of Franklin Simon & Co. A three-year average of excess profits was multiplied by five in this instance. In *Kinderman v. Kinderman*, 1920 (183 N.Y.S. 897) the plaintiffs contended that excessive salaries had been paid to the officers, who were the sole stockholders. The court, however, held that such salaries were properly deductible from profits before computing goodwill as five times the average net profits for the preceding three years.

Finally, in *Matter of Brown*, 1925 (211 N.Y.S. App. Div. 662) various other adjust-

<sup>21</sup> *Commercial & Financial Chronicle*, December 2, 1922, pp. 2425-6.

<sup>22</sup> A. C. Ernst: "Goodwill and its Valuation," *Printers' Ink*, March 19, 1925, pp. 125 ff.

ments were made. The transfer tax appraiser had originally valued the goodwill at three times the three-year average of annual earnings not attributable to investment or to the personal services of the partners in a stock brokerage firm. This method was rejected and the referee's action approved in excluding from the average all speculative profits, less the value of services allocated to the speculative business. In addition, a two years' purchase of net (excess) profits was declared to be more equitable, inasmuch as the goodwill was personal rather than commercial.

The trend of the representative decisions here considered appears to be directed toward greater accuracy in the determination of excess profits. This effort to exclude all elements of a normal return due the factors of production from the base of the goodwill computation is in accord with economic principles.

#### THE AMORTIZATION OF GOODWILL

On the subject of writing down goodwill, the opinion of the courts appears to be that that is a matter of internal corporate administration, to be governed by the judgment of the directors. In *Wilmer v. McNamara*, 1895 (2 Ch. 245; 64 L.J. Ch. 516) it was held that "where the value of the assets of a solvent company has fallen below the normal amount of share capital, the company, in the absence of any special provisions in its articles or of a contract binding the company, is under no obligation to make good such depreciation in the value of the assets before declaring a dividend out of the profits. Depreciation in the value of the leases and goodwill of a company is a loss of 'fixed' as distinguished from 'floating' capital. The balance sheet of the company cannot therefore be impeached on the ground that it does not charge anything against revenue in respect of the depreciation of goodwill."

In the leading American case of *Washburn v. National Wall Paper Co.*<sup>23</sup> the court declined to pass upon the present value of

the goodwill, declaring that "when the stock of a corporation has been issued for the goodwill of several separate business establishments and it is claimed that the value thereof has depreciated and that therefore the corporation has no right to declare a dividend, the court cannot determine that it has depreciated, in the absence of positive evidence of the value of such goodwill at the time of the issue of the stock and at a later time." Another American case declining interference with the value of intangibles is *Mellon v. Miss. Wire Glass Co.*, 1910 (78 Atl. 710; 77 N.J. Eq. 498), where it was held that "the corporation would not be compelled at the suit of the preferred stockholders to establish a sinking fund out of which to pay the par value of the preferred stock on dissolution of the corporation, on the ground that when the patents expired, in which nearly the whole capital stock of the corporation was invested, there would be no property out of which to pay the par value of the preferred stock; there being no obligation upon the corporation to do so in the absence of a contract."

There is even a case on record where goodwill written off was restored to the books in its original amount, in order that dividends might be paid out of the surplus so created. This step was endorsed by the court on the ground that it should never have been written off (*Stapley v. Read*, 1924, 93 L.J. Ch. 513). On the other hand, it was decided in *Fernald v. Frank Redlon Co.*, 1923 (140 N.E. 421; 246 Mass. 64) that "where goodwill, patents, etc. carried on the corporate books at \$55,256 were of only nominal value and the directors reduced the item to \$1, they violated no duty to the preferred stockholders, whose dividends were in arrears."

The obsolescence of goodwill due to Prohibition was given consideration in *V. Loewer's Gambrinus Brewing Co. v. Anderson*, 1931 (U.S.C.C. 352), permission being given for the amortization of its value over the period between the enactment of the law and its effective date.<sup>24</sup>

<sup>23</sup> For a discussion of similar cases see: *Journal of Accountancy*, Editorials, March and April, 1930, pp. 161-66 and 241-43.

<sup>24</sup> *Supra*, p. 327.

# CLASSIFICATION AND TERMINOLOGY OF INDIVIDUAL BALANCE-SHEET ITEMS

E. I. FJELD

**I**N A PREVIOUS article in ACCOUNTING REVIEW the results of analyses with respect to the general form and structure of the published balance sheet were given. In this article brief summaries will be presented as to the classification of individual items in the balance sheet, and the terminology used. It should be repeated that this study is based on the analysis of 587 balance sheets contained in the annual reports to stockholders of all the industrial companies having common and/or preferred stocks listed on the New York Stock Exchange. The data are based on the annual stockholders' reports for fiscal years ending in 1931-32.

## CURRENT ASSETS

**Cash**—Of the total cash items found in the balance sheets, 88.8% were classified as current, 3.8% under miscellaneous captions, and 7.4% listed as unclassified items. Those items not classified as current either occurred in statements where no attempt at classification was made, or represented funds tied up in some manner, as in closed banks or in connection with reserves of various kinds.

The term "Cash" without qualification was used in 44.0% of the cases to describe the current item, followed by "Cash in banks and on hand" in 18.9% of the cases.

**Receivables, Trade**—Accounts and notes receivable were combined in 25% of the statements. Of all the items under these

headings, 76.8% were classified under current assets, seemingly indicating that their current status had been given careful consideration.

The terminology most frequently used was "Accounts Receivable," which was used for 14.2%, followed by "Notes Receivable" for 7.0%, of the total receivables for all open trade accounts and notes. The designations of accounts and notes receivable were modified by the use of the descriptive terms "Customers" or "Dealers" in 24.3%, and "Trade" in 11.0%, of the statements.

**Receivables from Employees and Officers**—Receivables from employees and officers were classified under current assets in 43.6% of the statements in which they appeared, under other captions in 21.6%, and were included as unclassified items in 34.8%.

Where the purpose of the advance was mentioned, in 68 out of 94 instances it was for the purchase of stock. In 115 out of a total of 209 no mention of the purpose was made.

**Inventories**—In 390 out of 570 statements having inventories no classification of content of inventories was shown, a single amount being used for all inventories. In the balance sheets providing a classification for current assets, there were only two in which the inventories were not included under this caption.

A summary of the valuation methods follows, showing also the extent to which reserves were used:

	Number of balance sheets		Number of items		Reserves against items		Number of balance sheets having reserves	
Cost or market, whichever is lower	332	51.0%	423	48.9%	25	32.4%	17	34.0%
Cost	90	13.8	117	13.5	19	24.7	14	28.0
Cost or less	21	3.2	29	3.4	2	2.6	2	4.0
At selling prices	11	1.8	11	1.3	1	1.3	1	2.0
At market	12	1.8	14	1.6				
No basis of valuation given	140	21.5	223	25.7	27	35.0	14	28.0
Miscellaneous bases	45	6.9	48	5.6	3	4.0	2	4.0
Totals	651 <sup>1</sup>	100.0%	865	100.0%	77	100.0%	50	100.0%

<sup>1</sup> In several statements two or more methods of valuation were used, resulting in some overlapping and thus accounting for the apparent discrepancy between this figure and the total number of statements used in the study.

In 43 statements it was distinctly stated that the inventories were certified by someone other than the auditor.

There was a great variety in the terms used to designate the inventories, the one most frequently used, "Inventories," representing only 4.5% of the total inventory items, followed by "Inventories at lower of cost or market" in 3.7%.

*Other Current Assets*—Other items frequently classified under current assets, such as prepaid items, investments, life insurance policies, and treasury stocks and bonds, are discussed below.

#### *Importance of Current-Asset Classification*

—The classification of current assets is undoubtedly the most important of all items in a balance sheet, since current assets largely determine the solvency of a company. It follows that careful attention must be given to the classification of current assets. This is particularly important because the reader of the statement is not in a position to judge of the current status of, or the intention of the management in connection with, such items.

The question arises here as to whether current assets should be restricted to those which will be converted into cash in the normal course of operations, or whether they should also include other items which may be converted should the necessity arise. If it is the *intention*, for example, to convert the cash surrender value of a life insurance policy into cash, then it may without question be included as a current item, but if it is merely an item which is convertible without seriously interfering with the operation of the business, then its inclusion is questionable. To classify such an item as current under the first mentioned conception of current assets reflects not only its current status but the intention of the management as well; to classify it as current under the other conception results also in a statement of current status but not in any declaration on the part of management as to its intention. In this latter case it may well be merely a form of window dressing. Furthermore, its inclusion may be very misleading if the impression thereby given is that it is to be con-

verted, thus indicating a much more desperate financial condition than actually exists. The matter of intention should be given careful consideration in such cases, especially where wrong inferences might easily be drawn.

#### FIXED ASSETS

*Tangible Fixed Assets*—All the tangible fixed assets were combined in one amount in 55% of the statements, 323 in number. In the remaining balance sheets, where the tangible fixed assets were broken down into two or more items, there were 131 instances where the values of land and buildings were combined, making a total of 454 statements in which the value of the land was included with other values. This represents 78.5% of the balance sheets in which land was mentioned as one of the assets.

Land for industrial purposes is ordinarily not subject to depreciation. It should, therefore, be excluded from the other depreciable assets so as to reveal the valuation against which the reserve for depreciation is properly applicable.<sup>2</sup> The reader of the balance

<sup>2</sup> The ideal presentation is, of course, to show the accumulated depreciation for each class of fixed assets as a deduction from the group to which it applies, but necessary condensation makes this difficult or impossible in many published statements. When this method of presentation is used, land will be shown at book value, as it will not have any offsetting reserve. A good illustration is found in the form of balance sheet sponsored by the National Retail Dry Goods Association, as reproduced by Kester (Kester, Roy B., *Advanced Accounting*, Third Revised Edition, The Ronald Press Company, New York, 1933, p. 59). The same method of presentation is used by Finney (Finney, H. A., *Principles of Accounting*, Vol. I, Prentice-Hall, Inc., New York, 1934, p. 48). In the balance sheet sponsored by the Federal Reserve Board, land is included in the total fixed assets, from which the reserve is deducted (Federal Reserve Board, *Verification of Financial Statements*, U. S. Government Printing Office, Washington, 1929). The form provided by the Securities and Exchange Commission (Form A-1, p. 20) provides for the inclusion of all fixed assets in one item, but requires a detailed analysis in a separate schedule, which is even more desirable because of the additional information thus made available. Paton says: "Admitting the need for condensation in published statements it can still be insisted that the situation is not adequately displayed unless the extent of the estimated depreciation is shown in relation to the cost or other basic value subject to depreciation; and this requires the segregation of land and other forms of property which are deemed to be non-depreciable" (Paton, W. A., *Shortcomings of Present-Day Financial Statements*, *Journal of Accountancy*, Vol. LVII, Feb. 1934, p. 110).

sheet is then in a better position to judge of the adequacy of the depreciation reserve and the present status of such assets in comparison with other concerns in the same industry. While it is recognized that considerable condensation of ledger balances must be made for statement purposes, such condensation should take place in connection with the minor rather than the major items. To combine all the tangible fixed assets, particularly where their value is proportionately large, suggests an attempt to conceal rather than reveal details of the assets. There certainly can be no defense for the practice of including intangibles in this figure, as was done in eight statements.<sup>3</sup>

It is not only desirable that the method of valuation used for the fixed assets should be indicated in the balance sheet, but the numerous write-ups and write-downs which have taken place in the last decade suggest that it should be mandatory. Where the valuation is not indicated, it must be assumed that cost is used. In 84 statements it was specifically stated that cost was used, and in 97 that appraised values were used. In the remaining 400 statements no valuation method was mentioned.

In nine balance sheets some or all of the fixed tangible assets were carried at the nominal value of \$1. While this use of memorandum valuation is often defended on the doubtful basis of conservatism, it involves also the question of secret reserves. If the assets are practically worthless, then why assign any value to them? On the other hand, if they have value and are being used in the business and being depreciated periodically for income tax purposes, then it should seem that the stockholders and the public are entitled to this information.<sup>4</sup>

<sup>3</sup> It is significant that the Securities and Exchange Commission not only provides a separate classification for intangibles (Form A-1, p. 20) but specifically states in the instructions (p. 29) that "This schedule (Property Plant and Equipment) should not include intangibles, patents and trademarks, goodwill, organization expenses, etc., included separately in the balance sheet."

<sup>4</sup> In this connection it is extremely significant that the Securities and Exchange Commission (Form A-1, p. 29) not only requires an analysis of depreciation reserves and charges, but in addition "... a comparison of depreciation and depletion claimed to have been sus-

Fixed assets not used in operation were specifically mentioned in 32 statements, one-third of which were classified under "Other Assets." This is as it should be, for the fixed assets should be restricted to those used in operation.

The practice of showing additions and deductions to the fixed assets during the fiscal period was found in only 15 statements, usually with the net figure only shown. This information is important in indicating expansion or contraction of plant, and where space permits and the officers are desirous of keeping interested parties properly informed, it can well be included. A unique presentation of this kind is that found in the stockholders' report of the General Cable Corporation, wherein, on pages subsequent to the usual balance sheet, a "Descriptive Consolidated Balance Sheet" is presented. There every item in the first balance sheet is taken up, showing the balance at the close of the last fiscal year, total additions, total deductions (in a few instances the net figure), and balance at the end of the year. This might well serve as a model for other companies.

The variation in terminology was so great that no attempt was made to list any captions. There were 779 different titles used to list 1243 different items of fixed tangible assets.

*Intangible Fixed Assets*—Whether fixed or capital assets should include intangibles as well as tangibles is a mooted question.<sup>5</sup> In its

tained for the purpose of Federal income taxes and the amounts accrued through charges to income and/or surplus."

<sup>5</sup> See Hatfield, who states: "There is, therefore, an increasing tendency to list goodwill, franchises, and similar items, in a category distinct from fixed assets, either under these specific names or with the general heading of intangible assets. This seems the preferable procedure and is favored by Montgomery . . . and by Couchman. . . . Until recently it was almost universally the case that goodwill was not merely included among fixed assets, but was combined in a single item such as Plant, Machinery and Goodwill. But this practice is now very generally condemned. In England it is even considered illegal to include goodwill with fixed tangible assets in a single item" (Hatfield, Henry Rand, *Accounting, Its Principles and Problems*, D. Appleton and Company, New York, 1927, pp. 15-16). Kester states that, "The tangible assets, goodwill, patents, etc., are also classed as fixed" (Kester, Roy B., *Advanced Accounting*, Third Revised Edition, The Ronald

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broadest application, "fixed assets" certainly includes not only tangibles but all assets held as permanent or capital investments. And of these, goodwill may be said to be the most fixed of all, for all other assets may be disposed of without selling the business, but not so with goodwill. Accounting practice as represented by these balance sheets seems to favor distinctly the exclusion of goodwill and other intangibles from the fixed asset classification inasmuch as such items were thus classified in only 14.6% of the statements having intangibles. It is significant, however, that where they are classified at all, this classification is the one most frequently used, the next in order being deferred assets, 2.5%. The general practice is to show them as separate or unclassified items, this being done in 80.4% of the cases.

Goodwill was shown as a separate item in 86 balance sheets, once at zero, 31 times at \$1 and 54 times at values in excess of \$1. It was, however, shown much more frequently in combination with other intangibles, as well as tangibles, as indicated by the summary below. (In many cases it was combined with two, three or even six of the items listed.)

	At zero	At \$1	At more than \$1
Patents	3	63	52
Trade marks	1	42	49
Trade name		20	8
Brands		4	5
Formulae		4	7
Patent rights		9	7
Leaseholds		6	7
Licenses		6	5
Patterns		3	3
Contracts		1	8
Development		3	3
Copyrights		2	4
Rights		2	1
Water power rights		1	
Designs		2	
Other intangible assets		2	
Processes		2	3
Organization expenses		2	3

Press Company, New York, 1933, p. 28). Finney includes goodwill under fixed assets in a model balance sheet but after showing a subtotal for the tangible fixed assets (Finney, H. A., *Principles of Accounting*, Vol. 1, Prentice-Hall, Inc., New York, 1934, p. 48). Paton favors showing intangibles as the last item among the assets (Paton, W. A., *Shortcomings of Present-Day Financial Statements*, *Journal of Accountancy*, Vol. LVII, Feb. 1934, p. 121).

Drawings	1	2
Tangible assets	1	7
Leasehold improvements	1	
Models		2
Applications for patents		1
Magazine titles		2
Subscription lists		3
Reorganization expenses		1
Killing rights		1
Provision routes		1
Bookplates		1
Franchises		2
Tracings		1
Tangible Fixed Assets		8

Intangibles were shown at zero or extended short in seven different statements, in two of which it is stated that the intangibles are carried on the books at approximately 58 million dollars each but for balance sheet purposes are deducted from net worth. In the other statements there is no valuation given and if perchance the items represent actual values and cash investments, the creation of a secret reserve results. The same applies in the case of nominal valuations of one dollar, which appeared in 169 instances, without allowance for overlapping items.

While goodwill was set up as a separate item in 86 balance sheets, it was more frequently combined with other intangibles. The term "Goodwill" without modification was used to designate it in 68 cases, and explanatory words, such as "acquired for cash," added in the remaining 18 instances.

#### DEFERRED CHARGES

The theoretical distinctions between prepaid and deferred items, particularly with reference to classification, are not usually observed in practice.<sup>6</sup> Such distinctions were made in only seven statements.

<sup>6</sup> Probably the best discussion of this distinction is found in *Advanced Accounting* by Roy B. Kester. He divides such items into three classes: Those with a definitely fixed life, as prepaid rents, taxes, etc.; those with an indefinite life, as operating supplies; and those lump-sum expenditures, as above-normal advertising expenditures and factory rearrangements, where judgment rather than time or consumption furnishes the basis for charging to operations. The first two classes should, in general, be included in current assets, and the last under "Other Assets" (pp. 187-90). See also *Accounting Terminology* The Century Co., N. Y., 1931, pp. 46-47 and p. 60; also the *Accountants' Handbook*, Second Edition, W. A. Paton, Editor, The Ronald Press Co., New York, 1932, p. 16.

All deferred items were combined in one figure in 230 statements, in 206 or 89.6% of which they were listed as unclassified items. There were 826 deferred items in all, including those just mentioned, and 50.5% of these were classified under a deferred-asset caption, with 40.5% included as separate or unclassified items.

The exclusion of deferred items from the current-assets classification is probably more in keeping with creditors' requirements than with strict accounting theory; for such items are not usually considered by bankers and others as being available for the discharge of current obligations. They overlook the very obvious fact, however, that had the items not been paid for in advance, the cash would have been so much greater, and that prepaid items entering into the cost of product are usually recovered in the sales price of merchandise. Thus if not directly converted into cash, they are indirectly converted through the medium of receivables. Of course this may not be true where merchandise is being sold at a loss or on a very close margin. If there is any justification for the present practice, it is on the ground of conservatism and the relatively small amounts usually involved.

Where general terms are used, the ones most frequently found are "Deferred charges" and "Prepaid expenses," used in 10.9% and 5.6% of the cases respectively; where specific terms are used, "Prepaid insurance, etc." appeared in 2.9% and "Prepaid insurance, taxes, etc.," in 2.7% of the total number.

Discount and expense items on stocks and bonds were included in 93 statements, all on the asset side of the balance sheet, 68 being classified under a deferred-charge caption. The discount on stock applied only to preferred stock. Its inclusion under a deferred-charge caption is not good theory,<sup>7</sup> and,

judging by the fact that expenses of preferred stock financing were mentioned in four cases and only one of these included stock discount, it may be concluded that it is not good practice either. The inclusion of bond discount as a deferred asset is in accord with accounting theory. One writer, however, objects strenuously to it on the ground that it "... is no more an asset than is stock discount. To rule otherwise is equivalent to saying that the amount of property received by a corporation incident to the issue of bonds is always equal to the par or maturity value, regardless of the amount of the discount; and this is tantamount to denying the fact of discount."<sup>8</sup> It should, according to this writer, be deducted from the par value of the bonds issued, but not a single instance was found where it was handled in this manner.

#### INVESTMENTS

Of those investments which by their very nature are readily marketable and are never held for purposes of control, namely, government, state and municipal securities, 90.2% were classified under current assets, while only 2.0% of those which represent investments in affiliates and subsidiaries are thus classified, 47.5% of the latter being included under investments and 38.7% as unclassified items. Other investments, the nature of which is not disclosed, are divided almost equally between current assets, investments and unclassified items. There would seem to be no violation of accounting theory here. The details of classification are shown in the table at the top of the next page.

In the matter of valuation, however, the generally accepted basis of cost or market, whichever is lower, for marketable investments classified as current is not observed, about 44.5% of investments in the first

<sup>7</sup> While Paton distinctly disapproves of the inclusion of discount on stock as a deferred charge (Paton, W. A., *Shortcomings of Present-Day Financial Statements, Journal of Accountancy*, Vol. LVII, Feb., 1934, pp. 116 and 118), Kester would include it here "... if shown among the assets ..." (Kester, Roy B., *Advanced Accounting*, Third Revised Edition, The Ronald Press Company, New York, 1933, p. 394) but favors its in-

clusion as a contra account to capital (p. 466). Hatfield includes it as an asset in one illustration (Hatfield, Henry Rand, *Accounting, Its Principles and Problems*, D. Appleton and Company, New York, 1927, p. 205). Finney is in agreement with Paton and Kester in its treatment as a contra item (Finney, H. A., *Principles of Accounting*, Vol. 1, Prentice-Hall, Inc., New York, 1934, p. 69).

<sup>8</sup> Paton, W. A., *op. cit.*, p. 115.

	Government, state and municipal securities		Investments in affiliates and subsidiaries		Other investments	
Current assets	211	90.2%	6	2.0%	252	31.0%
Fixed assets			13	4.3	19	2.3
Other assets	3	1.3	22	7.2	72	8.9
Investments	12	5.1	145	47.5	225	27.7
Miscellaneous			1	.3		
Unclassified	8	3.4	118	38.7	245	30.1
Totals	234	100.0%	305	100.0%	813	100.0%

group being shown at cost in a period of falling prices. Cost was used in 23.6% of investments in affiliates and subsidiaries, with book value being used in 14.4% and no valuation method indicated in 44.6%. No valuation basis was mentioned in connection with 45.2% of miscellaneous investments, while cost was used in 26.8% of the latter. The analysis as to valuation follows:

under investments in 10.9% under "Other Assets" in 12.0%, and as unclassified in 19.3%.

The principle of valuation at the cash surrender figure seems thoroughly accepted, as there was only one instance where this value was not indicated in the title, and it was probably used nevertheless.

	Government, state and municipal securities		Investments in affiliates and subsidiaries		Other investments	
Cost	40	17.1%	67	22.0%	151	18.6%
Cost, with market value given	64	27.4	5	1.6	67	8.2
Cost or market, whichever is lower	13	5.5			13	1.6
Market	46	19.6	3	1.0	75	9.2
No basis for valuation given	50	21.4	136	44.6	367	45.2
Book value			44	14.4	12	1.5
Reserve used in valuation	21	9.0	39	12.8	123	15.1
Miscellaneous values			11	3.6	5	.6
Totals	234	100.0%	305	100.0%	813	100.0%

#### LIFE INSURANCE

Insurance on the lives of officers is merely another form of investment but for a different purpose. Theoretically it should never appear as a current asset with the possible exception of the period in which the face of the policy is to be collected, or a loan is to be made against the policy,<sup>9</sup> but actually it was classified in this manner in 57.8% of the statements where it appeared.<sup>10</sup> It appeared

<sup>9</sup> Bell, W. H., and Powelson, J. A., *Auditing*. Prentice-Hall, Inc., New York, 1932, p. 204; Kester, *op. cit.*, pp. 213-14.

<sup>10</sup> In a survey made by the Metropolitan Life Insurance Company, it was reported that 28 out of 39 statements classified the surrender value under current assets, 2 under investments, and 9 included it as an unclassified item. The report of this survey is probably the best treatment available on the subject, and is published under the title "Accounting for the Cash Surrender Value of Business Life Insurance," Metropolitan Life Insurance Company, New York, 1932.

#### TREASURY STOCK AND BONDS

From a strictly theoretical point of view, it is doubtful if treasury stock should ever be considered an asset. Much depends, of course, upon the definition or interpretation of an asset. The fact remains, however, that a corporation cannot be a stockholder in itself, and treasury stock cannot, therefore, be classified as an investment of the corporation. The effect upon the corporation is a return of some of the corporate assets to certain stockholders and a reduction in the number of shares outstanding. Both of these effects are properly recorded in the balance sheet only when the treasury stock is handled in the net worth section. The outstanding writers in accounting theory are practically unanimous in advocating this method of handling.<sup>11</sup> Nevertheless, it ap-

<sup>11</sup> Hatfield, Henry Rand, *Accounting, Its Principles*

peared on the asset side in 54.3% of the statements including treasury stock, and as a deduction from capital in only 45.5%. It appeared most frequently as an unclassified item, 28.9%, and under investments next, 15.8%. Treasury bonds, on the other hand, were deducted from the corresponding liability in 63.9% and included with the assets in 36.1% of the statements where included. The details follow:

<i>Treasury stock—</i>			
Current assets	15	3.3%	
Fixed assets	1	.2	
Deferred charges	1	.2	
Other assets	26	5.7	
Unclassified	132	28.9	
Investments	72	15.8	
Miscellaneous	1	.2	
Total under assets	248	54.3%	
Deducted from capital stock	208	45.5	
Footnote	1	.2	
Total on liability side	209	45.7	
Grand totals	457	100.0%	
<i>Treasury bonds—</i>			
Current assets	6	4.9%	
Fixed assets	1	.9	
Other assets	2	1.6	
Unclassified	20	16.4	
Investments	15	12.3	
Total under assets	44	36.1%	
Current liabilities	2	1.6	
Fixed liabilities	76	62.3	
Total on liability side	78	63.9	
Grand totals	122	100.0%	

There appeared to be no correlation between the handling of treasury stock and the auditors of the various statements, or between its handling and the state of incorporation. From this it may be concluded that whatever convictions practicing accountants may hold on the subject have been subordinated to the wishes of their clients. The lack of correlation with statute or legal requirements of various states may possibly be taken as recognition of the fact that "Ac-

countants' balance-sheets are intended to show what transactions have taken place and the present financial position; they are financial, not legal, exhibits."<sup>12</sup> The analysis of the treatment of treasury stock by the various auditors revealed the figures shown in the table at the top of page 337.

#### FUNDS

Sinking funds for bonds and other long-time obligations were deducted from the corresponding obligations in 54.2% and shown among the assets in 45.8% of the total items. Out of 71 items included among the assets, 43 were unclassified and nine each were included under investments and other assets, with 10 under other captions. Unless the funds are invested in the bonds which they are accumulated to retire, it is questionable whether they should ever be shown as deductions from the liabilities. Even when the funds have passed into the hands of trustees, the obligation remains one of the corporation until completely discharged.

Funds were provided also for the redemption of preferred stock, self-insurance, pensions, annuities, surplus reserves, depreciation and for other purposes.

#### CURRENT LIABILITIES

*Accounts Payable*—Accounts payable were listed without any qualifying words such as "trade" or "creditors" in 60.2% of the statements. "Trade" was used as a qualifying term in 6.6%, "Creditors" in 0.9%, "Trade Creditors" 5.3% and "Vendors" in 0.3%. The terminology most frequently used was "Accounts Payable," 66.2%, followed by "Accounts Payable, trade" 4.8% and "Accounts payable and accrued expenses" in 4.0% of the total terms employed.

*Liabilities to Officers and Employees*—Out of 27 items of this character, 14 indicated the reason for the obligation. With four ex-

and Problems, D. Appleton and Company, New York, 1927, pp. 181-82; Paton, W. A., *Shortcomings of Present-Day Financial Statements*, op. cit., pp. 112-13; Kester, op. cit., p. 182; Streightoff, F. H., *Advanced Accounting*, Harper & Brothers, 1932, p. 19; Finney, H. A., *Principles of Accounting*, Volume 1, Intermediate, Prentice-Hall, Inc., 1934, p. 88.

<sup>12</sup> Letter to the Editor, *Journal of Accountancy*, from F. W. Thornton, August 1933, pp. 151-53. See also the letter of Anson Herrick in the same issue, pp. 148-51, to which the above was a reply, relating to the legal and accounting requirements of treasury stock classification, and suggested methods of incorporating it in the balance sheet to satisfy both legal and accounting requirements.

Auditor	Balance sheets certified	Balance sheets without treasury stock	Treasury stock classified under		
			Assets	Net Worth	Both
A	115	29	41	37	8
B	62	12	20	28	2
C	52	12	18	16	6
D	45	10	17	15	3
E	37	13	11	10	3
F	29	12	12	3	2
G	23	6	8	6	3
H	17	6	7	4	
I	13	4	3	4	2
J	7	2	3	2	
K	7	2	2		3
L	6	1	3	2	
M	6	1	4	1	
N	6	1	2	3	
O	6	6			
P	6	5	1		
Q	6	4		2	
R	4	1	1	2	
S	4	1	1	2	
T	3	1	2		
U	3	1	1	1	
V	3		1	2	
Miscellaneous	78	27	24	25	2
Total certified	538	157	182	165	34
Statements not certified	49	26	15	8	..
Grand totals	587	183	197	173	34

ceptions they were all classified as current liabilities. Subscriptions by employees were treated as liabilities in 25 out of 29 statements. One item was classified under reserves, and three were treated as capital items.

*Notes Payable*—Inasmuch as notes payable are normally short-term notes, they should normally be classified as current, which was done in 88.2% of the cases. In 9.6%, where no current classification was provided or where the notes extended beyond the current period, they were shown as unclassified. The remaining items were classified under fixed liabilities (1.9%) and net worth (0.3%).

"Notes Payable" was used in 24.5% to designate this type of liability, followed by "Notes payable: Banks" in 7.7% and "Notes payable to banks" in 7.7%.

*Accrued Liabilities*—Accrued liabilities were combined with other obligations in only 12.7% of the statements where they were found, and were shown as separate items in 87.3%. Accrued salaries and wages

were shown as separate items in 20.9%. Accrued taxes were classified as current in 83.1%, income tax less frequently (80.8%) than general taxes (85.8%).

In connection with the terminology used, "Reserve" was applied to income taxes in 41.7% but to general taxes in only 12.2% of the totals, whereas "Accrued" was applied to general taxes in 79.8% and to income taxes in 15.8%. "Provision" was used to designate income taxes in 25.6%, and other taxes in 5.1%. The analyses are shown at the top of page 338.

*Dividends Payable*—In the designation of dividends payable, the date of payment was mentioned in 58.3%, the kind of stock in 47.1%, both date and stock in 33.3%. In 25.5% no information was given other than that of the liability for the dividend payable. Only three out of 204 dividend items were combined with other liabilities.

In several cases the liability was excluded from the current section because an offsetting asset was likewise excluded from the current-asset section. Where there was no

	Reserve for	Esti- mated	Provi- sion for	Accrued	Reserve and esti- mate	Accrued and esti- mate	Provision esti- mate	Accrued reserve
Income Tax:								
Listed as Income tax	68	23	50	20	5	4	4	2
Combined with other taxes	13		9	12		1		5
Combined with accruals	2			8				
Combined with accounts pay- able	2		2					
Combined with contingencies	3		2					
Combined with miscellaneous items	9		1	2				
Income taxes of prior years	14	1	4					
Totals	111	24	68	42	5	5	4	7
Percentages	41.7%	9.0%	25.6%	15.8%	1.9%	1.9%	1.5%	2.6%
Other Taxes:								
Listed as taxes	20	1		75		5		1
Combined with accruals	4		2	106				
Combined with accounts pay- able				8				
Combined with miscellaneous items	5		2					
Totals	29	1	12	189		5		1
Percentages	12.2%	0.4%	5.1%	79.8%		2.1%		0.4%
Total, all taxes	140	25	80	231	5	10	4	8
Percentages	27.8%	5.0%	15.9%	45.9%	1.0%	2.0%	0.8%	1.6%

contra item, the failure to classify it as current is quite improper, if payable in cash, because it not only must be satisfied out of current assets, but its exclusion distorts the working capital amount and ratio. In several instances it was mentioned only in a foot-note and was, therefore, neither deducted from the surplus nor shown as a liability, resulting in an overstatement of surplus and an understatement of liabilities. The reader of a balance sheet should not be called upon to make a number of mathematical calculations before he can arrive at the correct figures of a balance sheet; the officers and auditor are supposed to have done this for him.

#### FIXED LIABILITIES

Only 56.5% of the balance sheets showed fixed or long-term obligations. Of the total of such items, 42.2% were classified under a fixed-liability caption and an equal number were listed as separate items among the liabilities.

In 20 statements, the liabilities were deducted from the assets which secured them, with the net equity extended. This latter method may be clearly misleading to the reader of such a statement, who naturally looks for liabilities on the liability side. This

method is difficult to justify even if a mortgage was not assumed, for the inclusion of the equity as an asset is presumptive evidence of intention not to permit a foreclosure of the property. It might be added that if there were no such intention, most or all of the equity might be wiped out in a foreclosure proceeding, its inclusion in the first place thus having been of doubtful propriety.

The handling of liabilities on the balance sheet would be greatly improved if the recommendation of the American Institute of Accountants were followed, viz., "The period of one year is an arbitrary one adopted by accounting regulatory bodies as the dividing line between funded debt' (or 'long term debt' or 'fixed liabilities') and 'floating debt' (or 'current liabilities') and it is recommended that accountants consider the universal adoption of this plan for the sake of uniformity."<sup>13</sup> Many of the better balance sheets reflect this practice. Regardless of the number and nature of the obligations, they should be set up in such a manner, under appropriate captions, as to show definitely a total for current obligations and another for fixed obligations. It is permissible to use as

<sup>13</sup> *Accounting Terminology*, op. cit., p. 75.

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many sub-titles under a fixed liability caption as may be necessary to list the various types of obligations.

In some statements it may be necessary to include a miscellaneous or other liability caption to take care of items which cannot otherwise be classified.

#### DEFERRED CREDITS TO INCOME

Confusion in the use of the term "deferred" in connection with liabilities would be largely eliminated if the recommendation mentioned above were followed, for liabilities which are deferred because of their non-current character would be included under fixed liabilities, and the deferred caption would then remain for those items representing unearned income.<sup>14</sup>

Of the total items of this type, 50.7% were unclassified on the liability side, and only 23.6% were classified under a deferred-income caption.

#### MINORITY INTEREST

Minority interests were most frequently shown as separate items immediately preceding the net worth section, in 68.7%, and were included under net worth in 15.4% of the total cases. A separate classification for such interests was provided in 12.8%.

It is evident that the prevailing practice is to accord such equities the status of creditors rather than owners or stockholders of the business, or at least a status between the two. Writers on accounting theory are about equally divided as to the classification of minority interests as liabilities and as net worth items.<sup>15</sup>

<sup>14</sup> There is no confusion on this point among writers on accounting theory. Almost every textbook discusses deferred credits to income along with deferred charges. The confusion probably arises from the general meaning of the word deferred—something "put off"—in contrast with the technical meaning of the term. Fortunately Webster's *New International Dictionary* gives the technical accounting definition of a "deferred liability" as the equivalent of "deferred credit," or "income." On the other hand, a definition of this term is omitted entirely by the Committee on Terminology of the American Institute of Accountants in its report—*"Accounting Terminology."*

<sup>15</sup> Among the writers who include minority interests as liabilities, or as an item between liabilities and net worth, are the following: Bliss, James H., *Management Through Accounts*, The Ronald Press Company,

#### VALUATION RESERVES

*Theory versus Practice*—Writers in accounting theory are in practically universal agreement that valuation reserves should be deducted from the assets to which they apply.<sup>16</sup> A practice which is being followed in some statements of grouping all reserves under the caption of "Reserves" on the liability side, regardless of the nature of the reserves, is a clear violation of accounting theory. Much of the difficulty may possibly be traced to the unfortunate use of the term "reserve" to cover such diverse element as valuation accounts, actual liabilities, contingencies and appropriated surplus items.<sup>17</sup> Suggestions have been made for

New York, 1924, p. 474; Finney, H. A., *Principles of Accounting*, Prentice-Hall, Inc., New York, 1934, Vol. II, Ch. 48, pp. 7-10; McKinsey, James S., and Noble, Howard S., *Accounting Principles*, Southwestern Publishing Co., Cincinnati, pp. 631-32; Kohler, Eric Louis, and Morrison, Paul L., *Principles of Accounting*, McGraw-Hill Book Company, New York, 1931, 2nd Ed., p. 311; Montgomery, Robert Heister, *Auditing Theory and Practice*, The Ronald Press Co., New York, 1934, 5th Ed., p. 615; Stockwell, Herbert G., *How to Read a Financial Statement*, The Ronald Press Company, New York, 1935, p. 385; Streightoff, Frank Hatch *Advanced Accounting*, Harper & Brothers, New York, 1932, pp. 449-55.

Among the writers who include minority interests as a part of net worth are the following: Bell, Spurgeon, and Graham, Willard J., *Theory and Practice of Accounting*, American Technical Society, Chicago, 1935, p. 434; Bennett, Robert Joseph, *Corporation Accounting*, The Ronald Press Company, New York, 1916, p. 465; Couchman, Charles B., *The Balance Sheet, Its Preparation, Content and Interpretation*, The Journal of Accountancy, Incorporated, New York, 1924, p. 267; Eggleston, DeWitt Carl, *Modern Accounting Theory and Practice*, Wiley & Co., New York, 1930, Vol. II, pp. 108-27; Kester, Roy B., *Advanced Accounting*, Third Revised Edition, The Ronald Press Co., New York, 1933, p. 682; Newlove, George Hillis, *Consolidated Balance Sheets*, The Ronald Press Co., New York, 1926, p. 6; Rorem, C. F., *Accounting Method*, University of Chicago, 1923, p. 440; Sunley, William Terry, and Pinkerton, Paul W., *Corporation Accounting*, The Ronald Press Co., New York, 1931, pp. 461-63; and Taylor, Jacob Bacchus, and Miller, Herman C., *Intermediate Accounting*, McGraw-Hill Book Co., New York, 1933, p. 106 and p. 115.

<sup>16</sup> For opposing views, however, see *The Accounting Dictionary*, Frances W. Pixley, Editor, Sir Isaac Pitman Sons, Ltd., London, 1922, Vol. I, pp. 136-42; and Linsey, Bertram C., "Treatment of Depreciation Reserves on the Balance Sheet," *The American Accountant*, October, 1932, pp. 292-92. Mr. Linsey opposes the deduction of depreciation reserves from the assets because of the effect on ratios for analytical purposes, but excepts reserves for bad debts from this category.

<sup>17</sup> For a brief but very complete statement of the

the substitution of such terms as "provision" and "allowance" for reserve,<sup>18</sup> but they have not found favor in practice, as evidenced by the analysis of such terms which is shown below in connection with reserves for depreciation and depletion. Practice in this respect is in accord with the recommendation of the American Institute of Accountants, which favors the use of "Reserve for Depreciation" because it "is so generally used and understood by bankers, the business world and accountants that its use should be continued."<sup>19</sup>

**Reserve for Bad Debts**—A reserve for bad debts was referred to in 71.9% of the balance sheets, but the amount of the reserve was given in only 59.3% of these statements. Of the total bad debts reserves, with and without amounts, 96.8% were deducted from or mentioned in connection with the accounts to which they applied, but only 94.5% were handled as deductions from assets when the amounts were given.

The purpose of such a reserve seems obvious, for which reason, no doubt, a statement of the purpose was omitted in slightly less than half the cases, 242 out of 496. If the reserve, however, covers more than anticipated losses—as cash discounts—the purpose should be stated in detail.

different types of reserves, see *Accounting Terminology*, op. cit., pp. 102-7.

<sup>18</sup> Cole, William Morse, *The Fundamentals of Accounting*, Houghton Mifflin Co., New York, 1921, p. 107; Morrison, James, "Some remarks on the construction of balance sheets in general," *The Accountants Journal* (New Zealand), July, 1923, Vol. II, p. 5; Leete, Harry Osburn, "Terminology and Technique of the Balance Sheet," *Pace Student*, March, 1920, pp. 57-58, and April, 1920, p. 75.

<sup>19</sup> *Accounting Terminology*, op. cit., p. 105.

The term "Less reserves" without any amount was used in 25% followed by the same term with the amount given in 10.1%.

**Reserves for Depreciation and Depletion**—Depreciation (and depletion also wherever applicable) was mentioned in 97% of the statements, and the amounts were given in 86.4%. The balance in such a reserve is of much greater significance for analytical and comparative purposes than is true of bad debt reserves, particularly where the depreciable property is segregated.

In 90.3% of the cases the reserves were deducted from, or mentioned in connection with, the assets to which they applied, as shown below:

Deducted from assets, under:		
Fixed assets	439	68.4%
Unclassified assets	134	20.9
"Other" assets	4	.6
Current assets	1	.2
Investments	1	.2
Total under assets	579	90.3
On liability side, under:		
Reserves	39	6.1
Unclassified	23	3.6
Total under liabilities	62	9.7
Grand totals	641	100.0%

Depreciation and depletion were combined in 10.8% and depletion was shown separately in only 3.3%.

The terminology most frequently employed was "Less reserves for depreciation," 33.5%, followed by "Less allowance for depreciation," 8.7%.

A survey of the frequency with which such terms as "Reserve," "Allowance," "Provision," etc., were used reveals the predominance of the first. A summary follows:

	Amount of reserve not given	Amount of reserve given	Total	
"Reserve" used	25	419	444	69.3%
"Depreciation,"				
"Depletion" used without further qualifications	48	41	89	13.9
"Allowance" used	5	82	87	13.6
"Provision" used	2	7	9	1.4
"Accrued Depreciation"	2	3	5	.8
"Depreciation funds"	1		1	.2
"At depreciated values"	3	1	4	.6
No mention at all of depreciation	1		1	.1
"Reserve for accrued depreciation"		1	1	.1
Totals	87	554	641	100.0%

**Reserves for Amortization**—Reserves for amortization appeared in 114 statements, in combination with other reserves in 38 instances and as separate reserves in 76 cases. The amount of the reserves was given in 72 and omitted in 42 instances. In all but four cases they were shown on the asset side.

Reserves for amortization have no clearly defined usage, some statements having merely reserves without qualification, others reserves for depreciation, others reserves for depletion, and still others reserves for amortization for the same purpose. The expression is frequently used merely to indicate that an asset has been written down, such as an inventory, without giving any amount; in other cases the reserve is set up and used as any other reserve for valuation purposes. The variety of usages is indicated in the following summary:

	Amount of reserve not given	Amount of reserve given	Total
Combined with depreciation	2	21	23
Combined with depletion	2	1	3
Combined with depreciation and depletion	1	9	10
Combined with depreciation, depletion, and intangible development costs		2	2
Amortization reserve alone applied to:			
Leasehold improvements	12	13	25
Patents	13	10	23
Inventory	7		7
Licenses	1	4	5
Fixed assets	2	2	4
Trademarks		3	3
Investments		2	2
Advances to subsidiary		1	1
Discount on bonds	1		1
Mineral and royalty interests and contracts		1	1
Patent developments		1	1
Reorganization and financing expenses		1	1
Tools, dies, jigs and patterns	1		1
Unmineralized land values		1	1
Totals	42	72	114

**Reserves for Investments**—Reserves used for the evaluation of investments appeared 91 times, deducted from the asset in 77 instances (85%), classified under reserves in 10 statements and included as unclassified liabilities in four cases. The amount was not indicated in 42 items.

**Reserves for Inventories**—It is not usually the practice to use a reserve to write down an inventory, but it may properly be resorted to where it is inadvisable to disturb the book figures. Another use is to make proper allowance for anticipated losses upon liquidation of the inventory beyond the losses already provided for at the date of the balance sheet, as in a period of rapidly declining prices. The first should be a charge to revenue and the last to surplus, the reserve created in the latter case being an appropriated surplus reserve.<sup>20</sup>

Fifty inventory reserves were observed in 44 statements, 37 deducted from the inventories, 9 listed under reserves, and 4 included as unclassified items on the liability side. None was classified under net worth.

**Miscellaneous Valuation Reserves**—Other valuation reserves covered included: reserves for collection expenses, in 8 statements, 6 being on the liability side; reserves for discounts, appearing 57 times, always in combination with other reserves, deducted in 53 cases under assets; reserves for foreign exchange, in 24 statements, 5 deducted from assets and the balance on the liability side; and separate reserves for obsolescence in 5 statements, 3 as a reserve, one an unclassified liability and one deducted from assets.

#### PROVISION FOR CONTINGENCIES

Reserves were used to provide for contingencies in 44% of the statements. The classification of these reserves follows:

Unclassified among the liabilities	136	52.7%
Reserves	112	43.4
Net worth	4	1.6
Current liabilities	2	.8
Other liabilities	1	.4
Deferred credits	1	.4
Current assets	1	.4
Other assets	1	.3
Totals	258	100.0%

To designate the item, the expression "Reserve for contingencies" was used most

<sup>20</sup> Finney, H. A., *Principles of Accounting*, Vol. 1, Prentice-Hall, Inc., New York, 1934. Montgomery, R. H., *Auditing Theory and Practice*, 5th Ed., pp. 430-31; Straightoff, F. H., *Advanced Accounting*, p. 72; Taylor and Miller, *Intermediate Accounting*, p. 119.

frequently, in 57.4% of the total items, followed by "For contingencies," 18.8%, and "Contingencies," 10.8%, the latter two being used when classified under reserves.

These titles suggest the obvious criticism that the stockholders and others are usually kept in complete ignorance as to the real purpose of the reserve. Such a reserve lends itself to such extremes as covering up a liability the amount of which may not be known within a few dollars, or evaluating some asset, as investments, so greatly overvalued that to acknowledge it might bring discredit upon the officers and directors, or appropriating surplus for the sole purpose of deceiving stockholders as to their true equity and the accumulated profits available for dividends. No doubt many reserves cover all three purposes mentioned, in which case it can only be suggested that they should have been broken down accordingly and classified properly.

It is not intended to condemn all contingency reserves, for many, no doubt, are wisely provided, and at times it may not be advisable to disclose the purpose of the reserve. The large number, however, invites criticism. In speaking of such reserves, one writer states that "Such accounting should not be carried too far, however. There is no particular virtue in an appropriation of surplus as a reserve for possible losses except in those cases where there is specific reason for anxiety and some basis upon which to estimate the amount of the possible loss. The entire surplus might be transferred to an

account labeled 'reserved for possible bankruptcy' or some similar caption, but there would obviously be little point to any such accounting. The mere accumulation of surplus as such is ordinarily an adequate expression of the conservatism of the management."<sup>21</sup>

Many types of contingencies can best be provided for in footnotes to the balance sheet, particularly where the amount is not known or ascertainable, or uncertain.<sup>22</sup> Contingencies commonly covered by footnotes include unpaid cumulative dividends on preferred stock, notes and accounts receivable discounted,<sup>23</sup> guarantees of various kinds, contracts not completed, letters of credit, claims, options and warrants, sinking fund obligations, taxes and leases.

Of a total of 330 contingency items, 54.2% were shown in footnotes, 38.5% in the balance sheets, and 7.3% in the audit reports or certificates. While the auditor can best protect himself by including such contin-

<sup>21</sup> Paton, W. A., *Accounting*, The Macmillan Co., New York, 1924, pp. 729-34.

<sup>22</sup> Sanders, T. H., Reports to Stockholders, *The Accounting Review*, Vol. ix, No. 3, September, 1934, p. 217. Kester, Roy B., *Advanced Accounting*, Third Revised Edition, The Ronald Press Company, New York, 1933, pp. 410-15. Hatfield, Henry Rand, *Accounting, Its Principles and Problems*, D. Appleton and Company, New York, 1927, pp. 234-38. Finney, H. A., *Principles of Accounting*, Vol. 1, Prentice-Hall, Inc., New York, 1934, pp. 49, 173, 364-66.

<sup>23</sup> It is not to be inferred that this method of handling notes and accounts receivable discounted is approved. The amount of such items is always ascertainable, and it could, therefore, be more properly incorporated in the balance sheet itself. This was done, however, in less than half of the cases (30 out of 62).

Contingencies provided for	Total Number	Provision made in			Amount of Contingency	
		Balance Sheet	Foot- note	Audit Report	Shown	Not Shown
Cumulative dividend on preferred stock	93	50	42	1	31	62
Notes and accounts receivable discounted	62	30	30	2	61	1
Guarantees in connection with subsidiaries	41	10	30	1	38	3
Guarantees, endorsements, etc.	34	16	16	2	34	—
Contracts to purchase properties, stocks etc.	21	1	15	5	19	2
Letters of credit	20	5	11	4	19	1
Lawsuits and other claims	18	4	9	5	5	13
Options and warrants	18	6	11	1	10	8
Sinking fund obligations	9	2	7	—	2	7
Taxes	8	1	5	2	4	4
Leases	6	2	3	1	4	2
Totals	330	127	179	24	227	103
Percentages	100%	38.5%	54.2%	7.3%	68.8%	31.2%

gencies in his certificate, it would be well that they be mentioned also in connection with the balance sheet, since the certificate may not always be read. The amounts of these contingencies were given in 68.8% and omitted in 31.2%. As pointed out previously, the amount often cannot be ascertained at

SUNDRY RESERVES

Although 340 reserves were included under this title, the actual number of sundry reserves in the statements is very much less because in many cases several are combined under one title. The types of reserves and classification in the balance sheets are summarized below:

Reserve for:	Total	Deducted from assets	Current liabilities	Unclassified liabilities	Reserves	Net worth	Miscellaneous
Abandonment, adjustment and revaluation of assets	25	5		10	8	1	1
Advertising and promotion	13	1		6	6		
Purchase commitments and losses	24			3	11		10
Containers	4				4		
Coupons, stamps	7		3	2	2		
Development and experimental expense	7	1		2	4		
Guarantees, adjustments, etc.	12		1	3	7	1	
Insurance	143		5	52	79	7	
Operating	15		1	5	8	1	
Premium and discount on bonds	4	1		1	2		
Repairs, renewals, maintenance	34	3		5	26		
Pensions, annuities	31			8	20		3
Miscellaneous	21		4	9	8		
Totals	340	11	14	106	185	10	14

the date of the balance sheet. The detailed analysis is shown at the foot of page 342.

One of the most important of contingency items is the unpaid cumulative dividend on preferred stock. Here the officers of the companies can be a great deal more helpful to the readers of their statements by being more specific, that is, stating the exact amount of the arrearage. This was done in only one-third of the statements, and in the remaining two-thirds the reader was compelled to make some calculation to ascertain the amount. In 54 of 62 statements where the amount was omitted, the only information given was the date to which all dividends had been paid. In 45.2% the contingency was shown as a footnote, and in 34.4% in connection with preferred stock. The latter is preferable. The details follow:

Because of the extent to which unrelated items are combined in the same reserve for balance-sheet purposes, and possibly also on the books, and the paucity of information concerning their origin and justification, it is impossible to pass judgment upon them. No doubt it was the massing of various items under one heading with apparently little regard to proper classification, and with less regard to proper terminology, which led one writer to exclaim that "If there is any subject inside or outside the field of accounting that is beset by so many confusions, complications, and contradictions as that of 'reserves,' I have yet to hear of it."<sup>24</sup> Whether or not it is necessary to consolidate such items to the extent to which it is car-

<sup>24</sup> Strain, Myron M., "Reserves," *Certified Public Accountant*, March, 1933, Vol. XIII, p. 167.

Classification	Amount given	Amount not given	Total	
As a footnote	20	22	42	45.2%
In connection with preferred stock to which it applied	2	30	32	34.4
Shown short on liability side	9	9	18	19.4
In auditor's certificate		1	1	1.0
Totals	31	62	93	100.0%

ried, if the company officers and directors wish to keep the public and stockholders properly informed as to what has taken place, they could well follow the example of the General Cable Corporation in giving a brief analysis of the changes which have taken place in the various reserves during the year, showing the source of additions to the reserves and the amounts charged against them.

## NET WORTH

*Capital Stock*—Common and preferred stocks are usually set out in the balance sheet with considerable detail as to shares authorized and shares outstanding, with the unissued shares either indicated or easily ascertainable from the data given. Preferred stock, however, is insufficiently de-

items. It is with the latter that the accountant should be chiefly concerned, for the stockholders' chief interest in the annual report is their equity in the company, and for this purpose a greater distortion of the financial picture can occur because of the improper handling of these items than any others. The information given to the stockholders and the public is often so meagre that they are in no position to ascertain which items represent true reservations of surplus, the effect of which is a withholding of available earnings for distribution in the form of dividends, for one purpose or another, and those items which represent valuation reserves or liabilities.

A summary of the various reserves which seem to come under the category of surplus reserves and their classification follow:

Reserves for	Total	Net worth	Reserves	Unclassified liabilities	Current liabilities	Deducted from assets	Miscellaneous
Appropriated surplus	7	7					
Sinking funds	11	4	3	2	1	1	
Dividends	9	2	3	3			
Purchase and retirement of stock	24	22	1				1
Premium and discount on stock	13	9	1	2	1		
Extension and expansion	7		5	2			
Totals	71	44	13	9	2	1	2

scribed in most cases. It would be decidedly advantageous if the stock were described as cumulative or non-cumulative, and participating or non-participating, with unusual conditions explicitly set forth, so as to leave nothing to conjecture. The great variety of terms used can only be confusing, especially to the layman, for it may be presumed that the differences in nomenclature between several statements of what purports to be the same thing suggest some important but unstated differences in the stocks themselves.

*Surplus*—The equity of stockholders is not completely stated without the inclusion of all surplus items, be they reserved or free, in the net-worth section. This will include all unappropriated earned and unappropriated capital surplus items, concerning which there is general agreement as to classification, and the appropriated surplus

It will be observed that only 44 out of 71 were classified under net worth, the others being distributed in other sections of the balance sheet. When 7 reserves for sinking funds out of 11 are excluded from the net-worth section, it leads one to believe that the true nature of such a reserve is entirely misunderstood. If they are not appropriated surplus items, a proper explanation is certainly in order.

The classification of the surplus (or deficit) items in the statements follows:

On asset side	6
Under "Surplus"	59
Under net worth	309
Capital and surplus shown together as one figure	12
Surplus as unclassified item on liability side	178
Capital surplus only, earned surplus having been wiped out	20
Both capital and earned surplus wiped out; capital deficit	2
No capital or surplus; all wiped out	1
Total	587

Out of 73 deficit items, 53 were classified under net worth, five under surplus, eight were shown as unclassified items on the liability side, and seven on the asset side. (In addition to the six items listed above as

having been included with the assets, the excess of the liabilities over the assets, covered by the last item in the table above, was also included on the asset side.)

## DEPRECIATION UNDER THE INCOME TAX

EDWARD J. KIRKHAM

MUCH of the development in the accounting for depreciation and many of the accepted concepts of depreciation are of comparatively recent origin. However, the necessity for recovering the exhausted capital outlay before profits can be claimed has long been understood by many persons operating their own enterprises. In a recent article, Hatfield calls attention to the work of Vitruvius written in the first century B.C., wherein is laid down the rule that in valuing a masonry wall, one-eightieth of the cost should be deducted for each year the wall has stood.

### PROVISIONS IN THE BRITISH STATUTES

Early reports of the railroads show that provision was made for fixed assets wearing out; and in Parliamentary Debates we read that joint-stock companies, whose accounts were made up under the direction of auditors, were required to set aside a certain sum for the depreciation of machinery. But the early Income Tax Acts did not provide for the depreciation of assets. When they did begin to take cognizance of this deduction it was through an allowance for repairs. It was some years before depreciation was recognized, even in practice, as something apart from repairs. England began her income tax, as such, by the Act of 1798, yet it was not until the act of the following year that even an allowance for repairs was made.

The deductions allowed, divided into general and particular deductions from income, were specified in the Form of Return. The amount for repairs was limited in the case of the farm buildings of a homestead to 8% of the annual value, and where the

farm was occupied by a tenant, to 3%. In the case of non-farm houses and buildings, the allowance for repairs was limited to 10%.

The Income Tax Act of 1803 differed from the previous Acts in several respects. No general return of income from all sources was required, particular returns of income from various sources being substituted. The tax was, in effect, divided into five parts, each having relation to income derived from particular sources. The following schedules were set up: (1) Schedule A, the tax on owners of land, including houses; (2) Schedule B, the tax on farmers, including owners of land in occupation thereof, in respect of their profits exclusive of products concerned; (3) Schedule C, the tax on fundholders, was imposed upon all profits arising from annuities, dividends, and shares of annuities payable out of the public revenue; (4) Schedule D, although not the last in number, was, in effect, the final schedule in the scheme of the tax because it contained what has been termed the "sweeping clause."

The schedule was divided into two branches. Under the first, persons residing in Great Britain were charged upon income from "property situated in Great Britain or elsewhere, or from any profession, trade or vocation carried on in Great Britain or elsewhere." Under the second, all other persons, viz., non-residents in Great Britain, were taxed only on income arising in Great Britain or any profession, trade, employment, or vocation exercised in Great Britain. Finally Schedule E, charged income from any public office or employment, from annuities, pensions or stipends payable by the Crown or out of the public revenue.<sup>1</sup>

<sup>1</sup> Dowell, *Income Tax Laws* (5th Edition), p. xlviii.

The Act of 1806 made several changes in the previous laws but the only one of interest here was the elimination under Schedule A of the allowance for repairs to houses. That allowance was not reintroduced until 1894. The reason for the immediate abandonment, as stated in the Guide Book, was that it had been found to be "so inadequate and to operate so inequally, and to be demanded in many cases where the repairs were done by the tenants."<sup>2</sup>

Until the tax expired in 1816, no further changes were made in the law and no demand was made upon the government to allow for depreciation.

Industrial life changed in the period from 1816 to 1842 and when an income tax was again introduced into the British fiscal system it was necessary to make changes to provide for these new developments.

The allowance for repairs under Schedule D was governed by Rule 3 of Section 100, as follows:

In estimating the balance of profits and gains chargeable under Schedule D, or for the purposes of assessing the duty thereon, no sum shall be set against or deducted from, or allowed to be set against or deducted from, such profits or gains, on account of any sum expended for repairs of premises occupied for the purposes of such trade, manufacture or adventure or concern, nor for any sum expended for the supply or repair or alteration of any implements, utensils, or articles employed for the purposes of such trade, manufacture, or adventure or concern beyond the sum usually expended for such purposes according to the average of the three years preceding the year in which such assessment shall be made . . . ; nor on account of any capital withdrawn therefrom; nor for any sum employed or intended to be employed as capital in such trade, manufacture, adventure or concern; nor for any capital employed in improvement of premises occupied for the purposes of such trade, manufacture, adventure, or concern . . . .<sup>3</sup>

There were many glaring defects in this Act as well as the Acts of the preceding period due to their intended temporary nature. The fact that year by year the property was wearing out in spite of repairs and

would eventually need replacement did not occur to the makers of the law as an important item since each Finance Act was thought to be the last one that would include an income tax.

The fact that the law did not permit an allowance in respect to the exhaustion or consumption of a part of the assets of a concern soon gave rise to discussions of the problem, especially in the case of mines. Deductions were allowed for the actual replacement of utensils or plant used in the business but not for the using up of the mineral deposits. Complaints by the owners of mines were heard by the Select Committee of 1851 and the draft report, prepared by the Chairman (Mr. Hume) asked the Committee to state "that in respect to property in canals, docks, railways, and other works, as well as in mines and quarries which may be exhausted, the assessment is also unjust, as the tax is in many cases levied not on the profit only, but on a part of the capital." But the Committee made no recommendations and thus the proposal came to naught except for the passing interest it created.

The Select Committee of 1861 listened to testimony on the taxation of mines; the witnesses agreeing generally to the injustice of the existing practice, although they could not agree upon a remedy. The Chairman regarded as one of the most serious defects of the law the fact that capital, in the course of realization through the working of mines, was taxed in the assessment of the entire value of the mine's produce. Mr. Hubbard, as Chairman, proposed to allow in the case of rents or royalties from "metallic mines," one-fifth part of the annual value as a deduction, and one-tenth part in case of "earthy mines" and "quarries." He also proposed a deduction of one-sixth in the assessment of the annual value of the buildings, which allowance, he calculated, would not merely cover repairs and insurance but also provide a fund to replace the building when decayed by age. Mr. Hubbard no doubt realized that assets wear out and he was no doubt cognizant of the fact that they must be replaced if the business was to con-

<sup>2</sup> *Guide to the Property Tax Act, 1806*, p. 13.

<sup>3</sup> *Income Tax of 1842*.

tinue as a going enterprise. He considered that the only logical thing to do was to provide a fund against the time when this replacement would become necessary. However, the report was not accepted by his Committee which in the end came to no definite conclusion on this or any other matter.

Since there were those who were convinced that an allowance should be made for the exhaustion of a mineral deposit, it was an added grievance that nothing was allowed for the sinking of shafts or for the diminished value of those already sunk. Beginning in 1875, there was a series of cases in the courts pertaining to these points.

In *Addie & Sons v. Solicitor of Internal Revenue*,<sup>4</sup> the court provided that in ascertaining the profits from the business of coal and iron-masters the deduction of a percentage claimed for (1) sinking pits, and (2) depreciation of buildings and machinery, was not allowable. The Lord President said in passing judgment that "the making of a new pit in a trade of this kind is in every sense of the term just an expenditure of capital. It is an investment of money, of capital, and must be placed to the capital account in any properly kept set of books." This described the attitude of the courts with respect to any claim for a depreciation allowance. Reliance was placed by the Lord President on the third rule as to concerns under Case I and II of Schedule D, which provided that no deduction was to be made for "any sum employed or intended to be employed as capital."

In 1876, the case of *Forder v. Handyside*<sup>5</sup> was decided. It is advisable to review the facts and decision here since this case served as the rule until the Income Tax Act of 1878 became operative.

The company, carrying on business as iron-founders, set aside, in accordance with their articles of association, a sum of money from their net profits for the depreciation of buildings, fixed plant and machinery. In making a return of their annual profits or gains under Schedule D they claimed a de-

duction of this amount. During the period under review the company had written off repairs actually executed which, according to the law, they were entitled to do. The company claimed that the sums expended in repairs could not entirely replace the depreciation which had occurred and they were thus justified in writing an amount off as an additional deduction. The majority of the Commissioners were of the opinion that persons in trade were entitled to write off from their profits each year a sum for depreciation, and that the amount claimed in this case was in every respect just and reasonable and thus allowable. But the Surveyor, being dissatisfied with their decision, began suit to obtain the opinion of the court, the question being whether or not the claim should be allowed.

After reviewing the facts of the case and stating the law upon which the case was to be decided, the court held that where a company of iron-founders set apart a sum of money from their net profits for depreciation and claimed to deduct such sum from their return for income tax purposes, that such a deduction was contrary to 5 & 6 Vict., c. 35, Sec. 100, Case 1, Rule 3, as the amount set aside was, in effect, an addition to capital. Mr. Justice Heddleston, also sitting upon the bench, agreed that a prudent person would put something by for renewals but if the rule in *Addie & Sons v. Solicitor* was correct, then this was capital and came under the third rule of the section and could not be deducted for the purposes of the income tax. He was therefore forced to concur with the majority opinion.

Although the Act of 1842 did not mention depreciation, the practice became more liberal than the letter of the law. In 1877 in the House of Commons an amendment to the Act of that year was proposed which provided that, in addition to the deduction allowed from the profits or gains for the supply, repair or alteration of implements, utensils or articles used for the purposes of manufacture, a reasonable sum from such profits or gains be deducted to offset the depreciation arising from the wear and tear of such implements, utensils or articles.

<sup>4</sup> 1 Tax Cas. 1 (1875).

<sup>5</sup> (1876) 1 Ex. D. 233; 1 Tax Cas. 65.

In support of this amendment it was pointed out in the debates that, under a Treasury Minute issued several years prior to this discussion, those who had property in ships were allowed to deduct depreciation of 10 to 15%, but that any person being a printer, spinner, weaver or in any other trade was obliged to add back to the balance of profit any depreciation previously deducted.

Despite the apparent reasonableness of the proposed amendment, the Chancellor of the Exchequer said in reply to an interrogation that an allowance was then being made which came to substantially the same thing as that now asked—namely, a deduction for repairs and other fixed charges over a period of three years; but that to go further and allow depreciation was an unreasonable proposal, for it would, in fact, be allowing the deduction twice over. He also indicated that there was no standard by which depreciation could be tested, but that the Government was most anxious to deal fairly with each case brought before it.<sup>8</sup>

Even though the amendment was defeated by a majority of thirty-five votes, the reply by the Chancellor is interesting, especially the phrase "for it would, in fact, be allowing the deduction twice over." It is true that, in so far as a portion of the three years' average was made up of extraordinary repairs, any deduction for depreciation would embody, to some extent, a duplication of allowances as he claimed and should not be permitted. It does not follow, however, that allowable deductions for both the payments for repairs and the accrued depreciation could not be made in the same case. Property that has been subjected to use, even though maintained in serviceable condition by repairs, has a shortened expectancy of useful life. In such a case there should be a deduction for the payment of repairs made and for depreciation as well even though the repairs may have had the effect of prolonging the life of the asset.

The same question arose the following year. Led by the evidence of the prior year

the Chancellor had made inquiries regarding what could be done in the matter of an allowance for depreciation. In the different enterprises the practices adopted were found to be extremely various. In the case of shipping property the department of Inland Revenue allowed depreciation; for railway plant and for much machinery used in private establishments it was sometimes allowed. In other cases no allowance of any nature was made because the Commissioners did not think themselves authorized by law to permit it. The practice of allowing a deduction in one district and not in another on the same type of property served to make an inherently inequitable procedure even more unjust.

The rule laid down in *Forder v. Handyside* was therefore altered by the Customs and Inland Revenue Act of 1878, which, by Section 12 provided:

Notwithstanding any provision to the contrary contained in the Act relating to the Income Tax, the Commissioners for general and specific purposes, shall in assessing the profits or gains of any trade, manufacture, adventure or concern in the nature of trade chargeable under Schedule D, or the profits of any concern chargeable by reference to the rules of that Schedule, allow such deductions as they may think just and reasonable as representing the diminished value by reason of wear and tear during the year of any machinery or plant used for the purposes of the concern and belonging to the person or company by whom the concern is carried on; and for the purpose of this provision where machinery or plant is let to the person or company by whom the concern is carried on or upon such terms that the person or company is bound to maintain the machinery or plant, and deliver the same over in good condition at the end of the term of the lease, such machinery or plant shall be deemed to belong to such person or company.

And where any machinery or plant is let upon such terms that the burden of maintaining and restoring the same falls upon the lessor he shall be entitled, on a claim made to the Commissioners for general and special purposes in the manner provided by Section 61 of the Act of the fifth and sixth years of Her Majesty's reign (Act of 1842) to have repaid him such portion of the sum which may have been assessed and charged in respect of the machinery or plant and deducted by the lessee on the payment of the rent, as shall repre-

<sup>8</sup> *Hansard's Parliamentary Debates*, Vol. CCXXXIV, pp. 310-11.

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sent the income tax upon such an amount as the Commissioners may think just and reasonable as representing the diminished value by reason of wear and tear of such machinery or plant during the year. Provided, that no such claim shall be allowed unless it shall be made within twelve calendar months of the year of assessment.<sup>7</sup>

Certain features of this section are worthy of note. The deduction is allowed in respect of plant and machinery but nowhere in the Act do we find what is embraced in this concession. It is quite evident that the term was deliberately adopted for the purpose of confining the allowances to a particular class of assets. Implements and utensils were provided for by an allowance of the average sums expended in supplying, repairing or altering them. Expenses connected with premises and similar forms of capital were in no case to be deducted. Machinery and plant may therefore be roughly described as a middle class of assets, standing between implements and utensils on one hand and warehouses, minepits, etc., on the other. Among implements must be placed the type of the printer, the pickaxes of the contractors and the lamps of a gas company. Printing machines, steam-engines, trams and ships were to be considered as part of the middle class of assets.

The second matter for consideration is the meaning of "wear and tear." The term was not used to include every decrease in value but only that caused by "physical deterioration." The Special Commissioners refused an allowance in respect of certain new plant on the ground that during the first five years of its life that plant required no repairs and was therefore of the same value as when it was new. The case was upheld upon appeal.<sup>8</sup>

It had long been complained that real estate was assessed under Schedule A at its gross instead of its net income. The Act of 1894 provided that the assessment might be reduced by one-eighth in the case of farm lands with buildings thereon, and by one-sixth in the case of other buildings, so as to

permit deductions for repairs.<sup>9</sup> This was recognized at once as a substantial concession to the landowner and a decided improvement in the tax itself.

Although nothing was specifically said on the point, it may be inferred that the allowance was intended to cover the eventual replacement of the buildings. Sir Wm. Harcourt stated in the House of Commons that the rate of allowance was taken pursuant to Mr. Hubbard's recommendations of 1861, and reference to these proposals shows that he used the figure of one-sixth of the gross annual value as an amount calculated to cover the "ultimate renewal of the fabric when decayed by age," as well as repairs.

In the case of trade buildings occupied by their owners and used for securing income and not for residence, the difficulty was not entirely met by the one-sixth allowance even to the extent of structural decay. The deductions allowed for Schedule D were confined to the net Schedule A figure so that full tax was paid on the whole profits under the two schedules without any allowance for eventual replacement. Actual outlay, as may have been charged in the revenue accounts, was the only allowance made. This method of assessment effectively precluded any "decay" allowance.

The Select Committee of 1905 reported as follows on the definition of "wear and tear" as found in the Act of 1878:

The interpretation of this enactment has formed the subject of more than one reference by the courts, and even now it does not appear to be quite clear whether the judicial decisions obtained require the section to be read as meaning no more than this, that loss by depreciation may be allowed, even though no expenditure has been incurred in making it good by repairs, or meaning that, after all damages have been made good by repairs, short of renewals, a further allowance may be made in respect of the imperceptible and irremediable deterioration due to age.

The opinion of the Board of Inland Revenue and the practice follows the latter and more liberal interpretation which seems to us the correct one.

The opinion was quite reasonable. The same idea is now succinctly stated in Hat-

<sup>7</sup> 41 & 42 Vict., c. 15.

<sup>8</sup> *Caledonian Railroad Co., v. Banks* (1800) 1 Tax Cas. 487.

<sup>9</sup> *Hansard's Parliamentary Debates*, 1894.

field's classic sentence: "All machinery is on an irresistible march to the junk heap, and its progress, while it may be delayed cannot be prevented by repairs."

In 1897, the Association of Chambers of Commerce, mainly at the instigation of the Leicester Boot and Hosiery Trades, sent a memorial to the Chancellor of the Exchequer pointing out that in certain trades continual improvement in business machines was being made, and that in order to keep abreast of the times and competitors machinery had to be scrapped and replaced long before its useful life was completed. According to the law, the assessors were not permitted to make any allowance for obsolete machinery and they prayed that the law be altered to permit such a deduction. In answer to the memorial, the allowance for obsolete machinery was instituted "in practice" in 1897, but no steps were taken to bring this concession before the public. In fact it was not even brought to the attention of the Commissioners. A portion of the communication is quoted:

... that where a claim is made in respect of the introduction of more modern machinery in a factory, no objection is to be taken to the allowance, as a deduction from the assessable profits of the year, of so much of the cost of replacement as is represented by the existing value of the machinery replaced. Any excess in the cost of new machinery over the actual present value of the old, is an addition to the capital of the business and cannot be properly regarded as a charge upon revenue for the purposes of income tax assessment. . . .<sup>10</sup>

Several features of this correspondence is worthy of note but they will be deferred until later in the article. As introduced into the law, the allowance was practically the same as was provided in this letter.

It is necessary, at this point, to note in British practice that the allowance is not permitted as an ordinary trading expense deductible before arriving at the balance of profit and striking the average of the three years upon which the tax is assessed. It is

deducted from the average profits. For the purposes of the income tax, any deduction for depreciation as an expense made by the trader must be added back to the profits figure. A separate, special claim is then made to the Commissioners for an allowance on account of depreciation. The Commissioners determine the "just and reasonable" sum to be allowed, and after deducting the sum, the balance is the assessable profit under that Schedule. In this way the capital value of the plant and machinery upon which the allowance is calculated often differs from the value appearing upon the books of the concern. This may arise in two ways: (1) the rate at which depreciation is written off in the accounts year by year may exceed the rate allowed for wear and tear; in that case the amount allowed as a deduction for income tax purposes is smaller than that appearing upon the books as an expense, and (2) the rate at which depreciation is written off in the accounts may be less than the rate allowed for wear and tear; in that case the amount allowed as a deduction for income tax purposes is greater than that appearing on the books as an expense.<sup>11</sup>

Various grievances arose because the depreciation deduction was deducted from the average of profits. In a typical case where in bad years an average fell to £500, and the "just" allowance for wear and tear was £1000, the assessment stood £500 minus £500. Or, if the average for the three years was a loss, no part of the £1000 could be deducted. The Finance Act of 1907 allowed the unused balances to be carried forward indefinitely to future years until they were exhausted and thus gave another indication that the income tax had come to stay.

An example will clearly illustrate the principle of carrying a balance forward. Accounts are made up as of December 31 and the profits are as follows:

Year to			
December 31, 1907	£3000	Average	Average
December 31, 1908	1200		
December 31, 1909	120		
December 31, 1910	9000		
		£1440	£3440

<sup>10</sup> Saunderson, *Income Tax and Super-Tax*, 1923, p. 168.

<sup>11</sup> The capital value is usually taken as of the last day of the three years upon which the average is taken.

The assessment for 1910-11 would be made on the average profits of the three years ending December, 1909, which is £1440. The 1911-12 assessment would be based on the average of the three years ending December, 1910, which is £3440. The value of the machinery and plant account, as written down for income tax purposes, stood at £40,000 on the 31st of December, 1909, and the allowable depreciation was 5%. This expense was £2000 (£40,000 × .05) for 1910-11.

The 1910-11 tax assessment then would be as follows:

	£
Average assessable profits.....	1440
Less depreciation allowed.....	2000
Depreciation carried forward.....	560

The average profit for use in the 1911-12 assessment is £3440. From this deduct depreciation carried forward and the depreciation for the year of assessment. The plant and machinery account is as follows:

	£	£
31st December, 1909.....	40,000	
Less depreciation (1909-10).....	2,000	38,000
Plus additions less sales in year to 31st December, 1910.....		6,000
Value at December 31st, 1910.....		44,000
Depreciation at 5% = £2200		

The assessment would be made as follows:

	£	£
Average profits.....		3,440
Less depreciation carried forward....	560	
And depreciation for the year.....	2200	2,760
Assessable profit 1911-12.....		680

Had the assessment for 1911-12 been insufficient to cover the allowable depreciation, the balance unallowed would be carried forward indefinitely until the profits would permit the set-off.

The pressure of operating under war-time conditions and the heavy rates of income and excess profits taxes worked a revolution in income tax history at this point with respect to depreciation.

The original Excess Profits Duty statute contained the following comprehensive provision:

Deductions for wear and tear or for any ex-

penditure of a capital nature for renewals, or for the development of the trade or business or otherwise in respect of the trade or business, shall not be allowed except such as may be allowed under the Income Tax Act, and if allowed shall be of only such an amount as appears to the Commissioners of Inland Revenue to be reasonably and properly attributable to the year or accounting period.<sup>12</sup>

This rule in effect limited the deduction to the same amount which was deductible for income tax purposes,<sup>13</sup> but the section must be read in connection with another, Section 40 (3), which permitted special treatment in special cases.

Under the Income Tax Law no objections were usually made to variations in the amount expended for renewals and repairs from year to year, as it was considered immaterial in the long run whether such renewals were charged in one year or over a period of years. However for the purpose of the excess profits tax, the time of charging the renewals was important and the Board insisted upon adjustments. Thus if an asset was renewed once every twenty years and the whole expenditure was allowed for income tax purposes when incurred, an adjustment was necessary in order to obtain a proper comparison of the earnings of the pre-war period with the earnings of the taxable period. Otherwise the result might show an artificially low pre-war earning or an artificially low profit during the war period. In the cases in which a claim was made and admitted that the depreciation allowances were inadequate, the pre-war income was adjusted according to the new rate in order to provide a proper basis for the comparison. But where the rate of depreciation was considered adequate in the past but inadequate in the year of taxation, greater allowance was granted in that year without readjustment of the pre-war allowance.

Ordinarily depreciation allowances under

<sup>12</sup> Finance (No. 2) Act, 1915, Fourth Schedule, Part I, Rule 3.

<sup>13</sup> It should be noted that the phrase reads "such as may be allowed." This was not interpreted to mean "what have been allowed."

the Income Tax are limited to plant and machinery. Consequently, if depreciation was desired for other items, it was necessary to proceed by way of an appeal under Section 40 (3). This introduced great elasticity into the system. Such petitions could be presented when, among other things, there was loss due to "the postponement or suspension as a consequence of the present war, or renewals or repairs, or to exceptional depreciation or obsolescence of assets employed in the business or trade after the termination of the war."<sup>14</sup>

It should be pointed out that whereas ordinary depreciation was limited to plant and machinery this special section applied to exceptional depreciation or obsolescence of assets employed in the trade or business. It is also apparent that the assets subject to allowance for unusual depreciation or obsolescence did not need to be property specifically purchased for the manufacture of war materials. Any asset in the taxpayer's business adversely affected by the war came within the scope of the provision.

The extent of the loss which could be depreciated or amortized for the purposes of Excess Profits Duty was established on a liberal basis. The rule was that the amount subject to depreciation was the difference between "war value" (that is, the value of the assets at the beginning of the first accounting period when the Excess Profits Duty began to apply or the cost price if acquired after that date) and the "post-war value" (that is, the market value of the asset at the end of the last accounting period subject to the tax or some other post-war date later fixed). In other words, the total diminution of the value of the assets due to war conditions and occurring over the period of the duty could be charged off against the profits of the whole war period and not merely against the profits of the accounting period in which the loss was disclosed. War obsolescence was specifically mentioned among the grounds justifying appeal for special treatment from the Commissioner of Inland Revenue under this section.

In order to increase the supply of scrap metal during the war, manufacturers were urged to discard all obsolete machinery. The Inland Revenue Department did what it could to encourage this practice by ruling that sums realized from the sale of such machinery would not be subject to income and profits taxes as an ordinary receipt but should be held as a reserve for replacements. When the replacements were made the residual book value was to be written off as a charge against the profits of that year. In the case of the Excess Profits Duty an allowance was made for war obsolescence when setting the assessment for the year in which the plant was scrapped, notwithstanding the fact that it may not have been replaced.

In the administration of the Excess Profits Duty, England used both the "pre-war standard" and the "invested capital standard." The normal reasonable profit of an enterprise was determined by the device of a "pre-war standard." However, contrary to popular opinion, it was not merely an average of pre-war profits. As a matter of fact it was an alternative standard with a choice as to whether the criterion should be previous profits or return on the invested capital; and the option was in favor of the taxpayer instead of against him.

There were no fundamental changes in the statutes regarding the administration of the Excess Profits Duty. The same principles governed throughout the whole period; the amendments for the most part affected only details. This stability was undoubtedly a factor in the successful administration of the tax.

The various Customs and Inland Revenue and Finance Acts from the year 1842 were consolidated into the Income Tax Act of 1918.<sup>15</sup> Since this Act serves as the fundamental base for the subsequent Finance Acts, it is necessary, even at the risk of some repetition, to quote in detail the sections relating to the subject of this article.

Depreciation and obsolescence are provided for by Section 24 of the Act as gov-

<sup>14</sup> Finance (No. 2) Act, 1915, Sec. 40 (3).

<sup>15</sup> 8 & 9 Geo. 5, c. 40.

erned by Rules 6 and 7 to Cases I and II of Schedule D. Section 24 provides:

24—(1) Where an application is made to the Commissioner of Inland Revenue for the alteration of any amount of deduction for wear and tear, the Commissioners, unless they are of the opinion that the application is frivolous or vexatious, shall refer the case to the Board of Referees, and that Board shall, if they are satisfied that the application is made by or on behalf of any considerable number of persons engaged in any trade or business, take the application into their consideration, and determine the deduction to be allowed.

(2) Section 12 of the Customs and Inland Revenue Act of 1878, as amended by section twenty-six of the Finance Act of 1907, shall have effect as if the references therein to the diminished value by reason of wear and tear during the year of any machinery or plant included diminished value by reason of any machinery or plant having been temporarily out of use at any time during the year through circumstances attributable, directly or indirectly to the present war.

(3) In estimating the profits or gains of any trade, manufacture, adventure, or concern in the nature of trade chargeable under Schedule D, or profits of any concern chargeable by reference to the rules of that Schedule, there shall be allowed to be deducted as expenses incurred in any year so much of any amount expended in that year in replacing any plant or machinery which has become obsolete as is equivalent to the cost of the machinery replaced after deducting from that cost the total amount of any allowances which have at any time been made in estimating profits or gains as aforesaid on account of the wear and tear of that plant and machinery and any sum realized by the sale of that plant or machinery.

(4) Section nine of the Finance Act of 1898 (which relates to the amount of deduction to be allowed on the account of the annual value of the premises) shall not apply in the case of any premises being mills, factories or similar premises.

That is, if application is made by a number of persons for a revision in the rates allowed, the Board will review the allowance and determine the allowable deduction. The statutes here recognized obsolescence for the first time, although it had been deducted in some tax practices since 1897. Instead of classing mills, factories and similar premises with ordinary buildings, the law placed them in a class of their own.

Where the trader owns the premises which he occupies for the purposes of his business (and therefore must bear the Income Tax, under Schedule A, on these premises) he is allowed a set-off in arriving at his liability under Schedule D, of the amount on which he has actually paid the income tax, i.e., of an amount equal to five-sixths of the full annual value of the premises. This provision is necessary to prevent double taxation of the same item, once under Schedule A and again under Schedule D.

But, although the owner-occupier of the trade premises has actually (under Schedule A) paid taxes on only five-sixths of the annual value, he is allowed in the case of premises which are peculiarly subject to depreciation, mills, factories, and similar premises, to deduct the whole (i.e., six-sixths) annual value in computing his profit for assessment under Schedule D. That is to say, he is allowed every year, absolutely tax free, a sum equal to one-sixth of the annual value of the mill or factory which is in the nature of an allowance for wear and tear of the property caused by the vibratory action of the machinery housed therein.

The Royal Commission of 1920 took the position that there was no economic necessity for any general change in the British practice with regard to assets of a wasting character. The Commission further stated that if the wastage of the source of income is to be considered in every case it would be impossible to ignore the human element and it would be just as reasonable to give a corresponding allowance to a lawyer or a surgeon or a laborer in respect of the capital invested in his education and training.

It was also recommended that no allowance be given on account of wasting assets with a life of 35 years or more. It was felt that a time limit must be imposed and it was freely admitted that 35 years was an arbitrary period.<sup>16</sup> The sinking fund method was recommended and the allowance was to be the sinking fund payment necessary to

<sup>16</sup> The thirty-five year period was selected because of the fact that "reversionary interests to grant her or his heirs have little value if deferred for that length of time."

amortize the capital cost of the asset over its agreed life, less the sinking fund payment which would be necessary to amortize the capital cost if the life of the asset were 35 years. The rate of interest selected was  $3\frac{1}{2}\%$ . For example, if the agreed life of an asset, which cost £10,000, is 20 years, then under this scheme, the allowance would be:

£354 a sum which at  $3\frac{1}{2}\%$  interest would equal £10,000 in 20 years.

150 a sum which at  $3\frac{1}{2}\%$  interest would equal £10,000 in 35 years.

£204 the annual allowance to be made for depreciation.

Subject to the above limitation, the Commission recommended allowances in the case of all inherently wasting assets which have been created by an expenditure of capital. It was also recommended that the allowance for depreciation of mills, factories and similar premises should be subject to the general conditions governing allowances for all wasting assets and that obsolescence allowances should also be granted whether the obsolete assets were replaced or not.

In so far as the Committee advocated allowances for wasting assets not already provided by law, the recommendations can not be criticized. However, many assets were not covered and the 35 year limitation pares away relief which should be given. If the asset is the proper subject of an allowance it would be better, and more correct, to permit the allowances to the full extent of its cost, where its life could be determined with a reasonable degree of accuracy. These recommendations have not appeared in the acts as yet and it is quite doubtful if they will be accepted, at least for some years to come.

In view of the fact that by Section 33 of the Finance Act of 1926, losses sustained in a business may be carried forward and set-off against the profits of the six years following the year in which the loss was sustained, a great deal of controversy arose as to whether or not wear and tear allowances must first be deducted from the profits assessed for any year before setting off any loss under Section 33. The taxpayer obviously desired to set off the losses first, and

then the wear and tear allowances, since there was no time limit in respect of the latter. Section 17, of the Finance Act of 1932, one of the most complicated sections in a complicated code, now practically gives the taxpayer that right. The wear and tear must first be deducted, and then the losses brought forward, but the six-year time limit is repealed if full effect cannot be given to losses within that time owing to the deductions for those years in respect of wear and tear.

Section 18 of the Finance Act of 1932<sup>17</sup> made one further concession. The law includes the following: "Where, under Rule 6 of the rules applicable to Cases I and II of Schedule D, a deduction . . . is allowed . . . the Commissioners shall, either in charging the profits or gains, or by means of repayment, as the case may be, allow an additional deduction equal to one-tenth of the amount of the deduction allowed under the said Rule 6. . . ." The only reason given for this concession was that the taxes were high and business conditions poor. It was more the nature of a tax reduction rather than the recognition of the need for additional depreciation allowances.

From the foregoing discussion it will be seen that tax practice does not always agree with what might be termed "good accounting practice." A brief review and an analysis of the salient features of the various acts would not be out of place at this time.

The actual amount of the wear and tear allowance is determined by the Commissioners who assess the profits of the concerns. The Acts prescribe no rates but as a matter of fact the rates are quite standardized. As a result of conferences with representatives of the several trades the government has determined rates for the assets allowed to be depreciated in the various industries. An amendment to the 1918 Act established a definite form of procedure to alter the existing rates and to determine others, if the occasion arose.<sup>18</sup>

It provided that reference might be made to a Board of Referees upon application

<sup>17</sup> 22 & 23 Geo. 5, c. 25.

<sup>18</sup> Section 24 (1).

having been made for an alteration in the rates permitted for wear and tear when the application was "made by or on behalf of any considerable number of persons engaged in any class of trade or business." In this way, many deadlocks between the taxpayer and the taxing agency are avoided. However, a single individual cannot make such an appeal to the Board.

The method of calculating the allowance is based on the written-down value in the case of all objects except ships. The latter are generally regarded as having a definite "life" and the allowance in this case is calculated on the basis of a percentage allowance (based upon the number of years of estimated life) of the prime cost. For other assets the allowance provided is a fixed percentage on the written-down value and is deducted from the statutory profits of the year. It is at once apparent that the use of the written-down value as a base never reduces the value to zero. It is inevitable, however long a machine may be worked, that it has some more or less considerable value in the eyes of the Department of Inland Revenue. Complaint is often made that the rate per cent allowed on this basis is too low, but it should not be overlooked that the rate allowed must not provide more than a fair annual amount the first year. On this basis, if the estimated life of the plant is twenty years, the rate allowed the first year would be limited to five per cent, for otherwise the allowance for that first year would be excessive. The fact that it takes about fifty-eight years to write off the cost of the plant having a scrap value of five per cent, if a rate of five per cent on the reducing balance be employed, is no reason for allowing a more than adequate amount, being one-twentieth of the cost, out of the revenue receipts of the first year.

The taxpayer may at his option deduct the entire cost of renewals, when such renewals are made, in lieu of claiming a yearly allowance for depreciation. Where an annual wear and tear allowance has been granted in respect of plant and machinery, the actual cost of renewing the particular objects on which allowance has been granted will not

be admitted as a charge against the profits, but must be regarded as a capital expenditure. On the other hand, where the taxpayer has not claimed an annual allowance for wear and tear, he will be allowed to claim as an ordinary business expense the actual cost of renewing the plant or machinery or other subject which might have been eligible for a "wear and tear" allowance.

The amount which will be admitted as the cost of renewals is restricted to the net cost of replacement of an article similar in all respects to the one replaced, diminished by the sum realized on the sale of the replaced asset. The cost of replacement is the cost of the new asset and not the cost of the old one. If the article, which replaces the old asset is of a superior type, a disallowance will be made of part of the cost of the replacing article to represent the value of the improvement in the latter compared with the original which it replaces.

Although the cost of renewals of plant and machinery will not be admitted as a business expense where a wear and tear allowance has been granted on plant and machinery, the cost of renewal is not considered to cover the cost of renewing parts of machinery which become worn out and require replacement, provided the replacements are not of such a nature or so extensive as to destroy the identity of the object on which the allowance for wear and tear has been allowed.

Several important points emerge from the wording of the Act of 1918. It is seen that the allowance is made in "charging the profits." It follows that the deduction is to be made from the ascertained figure of profits representing the assessable liability. For income tax purposes depreciation is not regarded as an expense to be charged before profits are determined; but a corresponding allowance is given after profits, as so understood, have been computed. Viewed from the standpoint of the government the depreciation allowance is more in the nature of a surplus reserve.

It is also important to understand that the phrase, "during the year" refers to the fiscal year and that this year is never the

same as the accounting year of the particular undertaking. The scheme of the income tax is that the profits of a particular accounting year form the basis of taxation in the fiscal year which commences next after the close of the said accounting period. Thus the practice is to ignore the charges made by any particular concern and to substitute a different sum in lieu of that amount. It can be easily seen that the wear and tear allowances for purposes of the tax have no necessary relation to the amounts charged on the books of the trader; and the influence of the book charges upon the Commissioners when they are considering the "just and reasonable" allowance is slight.

In addition to the allowance in respect of wear and tear, a further concession may be obtained in certain circumstances when obsolescence is proved. Since this term is strictly interpreted, it is desirable that space should be given to a consideration of its exact meaning. Any machine may become unfit or unsuitable to the work for which it was installed. Several factors may be responsible: it may be destroyed, it may become worn out, the nature of the business may change, or it may be rendered obsolete by the invention of a more efficient machine. It is only in this latter case that the concern is entitled to an allowance for obsolescence. The machinery must be still fit to do its work and only put out of use by the introduction of a more up-to-date machine which renders it unprofitable to continue working the old one.<sup>19</sup> For this reason it is essential that there be a replacement by a new machine if the allowance is to be claimed. In the case of the *South Metropolitan Gas Company v. Dadd*,<sup>20</sup> it was held that if replacement was merely advisable but not imperatively necessary, the Commissioners could find as a question of fact that there was no obsolescence involved.

The method by which the obsolescence allowance is made, like that for renewals and unlike that for depreciation, is by a deduction from the profits of the year in which the event takes place. The allowance

consists of so much of the amount spent on the replacement as is equivalent to the cost of the old machine, after deducting from that cost the amounts already allowed in respect of wear and tear and any sum realized through sale. If the amount expended on the new machine is less than the amount lost upon the old, the allowance is confined to the former amount. These principles can best be illustrated by the following example.

A machine was purchased in 1927 for £1200. Alterations were made in 1930 at a cost of £300, but the machine had to be discarded as obsolete in 1931, in favor of one costing £850. The amount realized from the sale of the old asset was £200. The computation follows:

	£	£
Cost price March 31, 1927		1200
Wear and Tear, 1927-28	90	90
Written down value 3/31/28		1110
Wear and Tear, 1928-29	88	88
Written down value 3/31/29		1027
Wear and Tear, 1929-30	77	77
Written down value 3/31/30		950
Wear and Tear, 1930-31	71	71
		879
Additions 7/1/30		300
Written down value 3/31/31		1179
Wear and Tear, 1931-32	88	88
Written down value December 31, 1931		1091
Amount realized through sale		200
Prima facie amount of claim on account of obsolescence (which must be restricted to the amount expended on replacement, i.e., £850)		891

It will be recognized that obsolescence claims arise only when wear and tear has been claimed in earlier years, since in the event of such allowances not having been given, the loss on account of obsolescence is covered by the normal charge for replacements.

Although many accountants use the word "depreciation" in a broad sense to include both the inevitable and the contingent losses in value, the British Tax System distinguishes sharply between the two. Depreciation is considered as embracing only the loss in value because of wear and tear in use, while obsolescence appears only when the introduction of a more modern machine renders obsolete the one already in use.

<sup>19</sup> Evans & Phillips, 4 A.T.C. 520.

<sup>20</sup> 6 A.T.C. 983.

There is no provision in the English law where an allowance is permitted for something that is liable to happen in the future like expected obsolescence. The loss must not only be realized through sale but the asset must be replaced with a machine capable of carrying on the work of the old. However, in theory a loss from obsolescence may be experienced regardless of whether or not the asset is replaced by another. The only explanation of the disregard for the theory is the "practice" of the country. The law is worded almost identically with the communication sent to the representatives of the Leicester Boot and Hosiery Trades in 1897. Since it was the intent of these trades to introduce new machinery for that rendered obsolete, the practice of allowing the loss has only been granted to those who actually replace the old article rendered obsolete. In this respect the law is quite unfair to the taxpayer.

Another quaint feature of the system is the allowance for depreciation of mills, factories, and similar premises. At the most the method of providing the allowance is unscientific and extremely arbitrary. A vast improvement, which has been asked for many times but always denied, would be to allow the depreciation as a percentage of the cost of the property instead of a fraction of the annual value.

Recent additions to the Act allowing determination of the percentage by an independent Board of Referees and a standardization of the rates in particular trades have done much to dispose of grievances in respect to depreciation. The scope of the present allowance should however be extended to all assets instead of being restricted to plant and machinery since there is no clear distinction between depreciation for various classes of assets. There is little or no recognition given to the fact that real income arises from the possession of such assets only after proper allowance has been made for the capital outlay used to acquire them. The income tax is heavier upon the income from such assets than upon income from other sources.

The breadth of this subject has precluded

a detailed analysis of the minute details found in the law, but it is hoped that the material presented will make possible a clearer understanding of the development of depreciation allowances in the income tax statutes of Great Britain.

#### PROVISIONS IN THE STATUTES OF THE UNITED STATES

Although the first suggestion of an American income tax law was made by Secretary Dallas in 1815 it was not until the Civil War that the government again approached the problem of such a tax. Secretary Chase did not think that income could be taxed under the Constitutional provision regarding taxation; nevertheless a tax was passed in 1861, not as a "direct tax" which was prohibited by the constitution, but as an "indirect tax."

The Act of 1861 was never put into effect largely because Secretary of the Treasury Chase did not favor it. His objections to it were voiced in his report of 1861 and it was not included in his proposed system for the following year. The Ways and Means Committee however with a clearer vision of the fiscal needs increased import duty rates and included an income tax in its proposals. The income tax was passed by the Congress in 1862 to operate for a period of three years. The law provided that income below \$10,000 be taxed at 3% and all over \$10,000 at 5%, all taxes being figured only after allowing an exemption of \$600. Citizens living outside the country however were taxed at 5%.

The laws of the civil war period were silent about depreciation, yet like their British antecedents, they made an allowance for repairs by the following section:

Section 117—In estimating deductions from income . . . the amount usually paid out for usual or ordinary repairs, not exceeding the average paid out for such purposes for the preceding five year, shall be deducted, but no deduction shall be made for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of the estate or property.<sup>21</sup>

<sup>21</sup> Horace E. Dresser, *The New Internal Revenue Act, 1864*, Sec. 117, p. 68.

The history of the income tax during the civil war period and the purpose of this article would not be complete unless attention was called to the attempts of the Confederate government to produce revenue. The Confederacy, like the Union, started out with a direct tax on all property. However when the Confederate Congress convened in 1862 it became apparent that the aversion of the people to this war tax of  $1\frac{1}{2}\%$  was so great as to render it practically useless. Secretary of the Treasury Memminger called the attention of the Confederate Congress to the lack of revenue and asked that the tax rate be increased in spite of the people's opposition. The Congress declined and the Secretary was forced to rely chiefly upon the sale of bonds even though there was little capital seeking investment.

The experience with the war loans was a repetition of that with the property tax. In 1863 Memminger declared that he preferred a tax on both property and income, the income tax to be paid not only in money but also in kind. The Confederate Congress adopted these suggestions and a few months later enacted a comprehensive tax measure.

This law imposed a direct tax of 8% on naval stores and agricultural products, as well as a tax of 10% on securities and capital invested in a business which was not otherwise taxed. The law also provided a series of license taxes on trade, business, and occupations, some of them specific taxes and some of them calculated according to gross receipts. Then followed the provisions affecting income; a salaries tax was followed by the income tax proper. This was imposed on "income and profits derived by each person, joint-stock company and corporation, from every occupation, employment or business, and from every investment of labor, skill, property or money, and the income and profits derived from any source whatever except salaries."

The allowable deductions were elaborated in a series of six provisions. From the incomes from real estate (other than houses) a deduction not exceeding 10% of the gross rent was permitted for necessary annual repairs; in the case of houses the total deduc-

tion was limited to 5%. From the income of mining and manufacturing businesses a deduction from the "gross value of the products of the year" was permitted for rent as well as the cost of labor and raw materials. From the income of navigating enterprises, deductions from "gross earnings, including the value of freights on goods shipped by the person running the vessel," were allowed to the extent of the hire of the boat, if not owned by the person running the same, or if owned by him, a reasonable allowance for wear and tear of the same, not exceeding 10% per annum, and also the cost of running the boat or vessel."<sup>22</sup> Various other deductions were permitted but they are outside the scope of this investigation.

Thus we can see that the first statutory recognition of wear and tear, for the purposes of income tax, was made by the Confederate States. It was some years later (1878) that Great Britain recognized it in her laws and even a greater number of years (1909) before it was recognized by the American Federal Government.

Why the Confederacy should introduce such a provision in their income tax is difficult to explain. With the North composed of large manufacturing units and the South primarily made up of agricultural groups one would believe that the North would have introduced the provision before the South. But such was not the case. The class of assets to which it applied suggests a possible explanation but this is in no way conclusive as to the real reason. The South had depended for years upon the New England shippers for the transportation of their products. With the outbreak of the war this service was hampered to a great extent both by the Northern blockade and the feelings of the New Englanders. The products produced in the South had to reach market by some means and the Confederacy lost little time in attempting to create a merchant marine. It would seem that the allowance for wear and tear of ships was a direct concession to further this end.

After the closing of the war in 1865 and

<sup>22</sup> Seligman, *The Income Tax*, pp. 484-86.

the break-up of the Confederate government, little attention was directed to a new revenue system in the south. The experiment of the Confederacy with the income tax is an unfinished chapter in fiscal history. What might have happened under more favorable circumstances is a useless though interesting speculation.

The tax laws of the federal government for 1862, 1864, 1867 passed out of existence in 1872 with little controversy, and for two decades the idea of income taxes disappeared from the minds of the public. In the presidential message of 1893 a tax was proposed upon the income of corporations but as introduced into Congress the bill provided for a general income tax. The law of 1894 was practically a copy of the Civil War legislation with an addition for corporations, and the tax upon them was to be levied at 2% on all incomes over \$4,000. It may be assumed that since it was a direct copy of the prior acts, decisions under those laws would influence the operation of the 1894 measure. As a result, estimated depreciation could not be deducted<sup>23</sup> until the property was disposed of and the loss realized.<sup>24</sup> But these matters are decisions of the Commissioner of Internal Revenue and can be found nowhere in the Statutes.

Scarcely had the declaration of income began to come in when the constitutionality of the law was questioned. In the famous case of *Pollock v. Farmers' Loan and Trust Company*,<sup>25</sup> the Supreme Court, by a five to four decision, declared the tax to be a "direct levy" and thus unconstitutional.

With this decision standing there as only one way in which the United States could have an income tax—an amendment to the Constitution. This came later; but in the meantime the courts had occasion to consider depreciation in some of the cases before them.

In the absence of statutory provisions, they were slow in recognizing the necessity of providing for depreciation. The early court cases in this country distinctly show a

failure to understand the nature of this important element of cost.

In *Tutt v. Land*,<sup>26</sup> a Georgia court refused to allow a charge for depreciation before arriving at the distributable net profit, saying in part:

It is not pretended that the value (of partnership assets) was lessened by reason of damage or injury from accident or other special cause. Had it been, there might probably be force in the question whether it was not a claim under the head of losses, and therefore properly chargeable to the firm. But it appeared that it was only the ordinary, natural depreciation that may occur in all things.

In 1878 the Supreme Court supported the government in its claim that a railroad company should not be allowed to include a depreciation charge in operating expenses, holding that "only such expenditures as are actually made can with any propriety be claimed as a deduction from earnings."<sup>27</sup>

The misunderstandings began to clear up with the case of *Jennery v. Olmstead*.<sup>28</sup> There the court said:

In brief, if anything happens by which the bank sustains permanently and plainly a depreciation in, or total obliteration of, the value of property, such depreciation or obliteration must be regarded as a loss sustained, and such loss must be deducted from the profits before the net profits can be arrived at.

Cases following this did not conform, in all instances, to the above. While several recognized the necessity of making an allowance for depreciation,<sup>29</sup> several others failed to see it as a proper charge. In California the idea of allowing depreciation was ridiculed by one of the judges as "all wrong" and "not to be tolerated for a moment."<sup>30</sup>

In speaking of tunnels, wells, reservoirs and real estate, a California Court said:<sup>31</sup>

<sup>26</sup> (1873) 50 Georgia 339.

<sup>27</sup> (1878) 99 U.S. 459; *U.S. v. Kansas Pacific Ry. Company*.

<sup>28</sup> (1885) 36 Hun 536.

<sup>29</sup> *Conville v. Shook* (1898) 24 NYS 547; *Whittaker v. Amwell National Bank* (1894) 52 N.J.Eq. 400, 29 Atl. 203; *Reagan v. Farmers' Loan and Trust Company* (1894) 154 U.S. 362.

<sup>30</sup> (1897) 50 Pac. 633.

<sup>31</sup> (1897) 118 Cal 582; *San Diego Water Company v. San Diego*.

<sup>23</sup> 1 Internal Revenue Record, p. 109, 197.

<sup>24</sup> 7 Internal Revenue Record, p. 59.

<sup>25</sup> (1894) 157 U.S. 429; 168 U.S. 601.

There is no depreciation of these things, there is no wear and tear, no permanent and gradual destruction by use and age. Most of them stand as everlasting as the hills.

The same view was expressed in an Iowa case, *Cedar Rapids Water Company v. Cedar Rapids*,<sup>32</sup> where the court said that it saw no reason why the company should be allowed to charge profit and loss for depreciation in addition to operating expenses and repairs.

However the California and Iowa decisions were reversed when, in the leading case of *Knoxville v. Knoxville Water Company*,<sup>33</sup> the Supreme Court used the following language:

A water plant, with all its additions, begins to depreciate in value from the moment of its use. Before coming to the question of profit at all the company is entitled to earn a sufficient sum annually to provide not only for current repairs, but also for making good the depreciation and replacing the parts of property when they come to the end of their useful life. The company is not bound to see its property gradually waste, without making provision out of its earnings for its replacement. It is entitled to see that from earnings that the value of the property invested is kept unimpaired, so that, at the end of any given term of years, the original investment remains the same as it was at the beginning.

In the recognition of the necessity for providing for this important element of cost, the Interstate Commerce Commission has been a most important factor. In its accounting rules which went into effect in 1907 it was definitely prescribed, for the first time, that a regular allowance, estimated monthly, must be made for the depreciation of seven named classes of equipment.<sup>34</sup>

With the court cases recognizing depreciation as an element of cost it was not too much to expect that it would be afforded some recognition when the income tax again took its place in the American fiscal system.

It was not until 1908 that the subject of an income tax again arose; in that year both political parties were in favor of such a tax. As a result of campaign promises, when the

Payne-Aldrich Tariff Bill became a law in 1909, a 1% tax on corporation incomes in excess of \$5,000 was included in the measure.

After establishing the rate upon net income, Section 38 (2) provided that net income should be ascertained by the deduction of certain items from the gross amount of income. Among these was the broad statement: "All losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any."<sup>35</sup>

The question of what is a "reasonable allowance" for depreciation is one that depends upon the circumstances of each particular case. The general rule prescribed for the law by the Commissioner of Internal Revenue was as follows:<sup>36</sup>

The deduction for depreciation should be the estimated amount of the loss, accrued during the year to which the term relates, in the value of the property in respect of which such deduction is claimed, that arises from exhaustion, wear and tear or obsolescence out of the uses to which the property is put, and which loss has not been made good by payments for ordinary maintenance and repairs deducted under the heading of expenses of maintenance and operation or in the ascertainment of gross income. This estimate should be formed upon the assumed life of the asset, its cost value and its use. Expenses paid in any one year in making good exhaustion, wear and tear or obsolescence in respect of which any deduction for depreciation is claimed must not be included in the deduction for expenses of maintenance and operation of the property or in the ascertainment of gross income, but must be made out of accumulated allowances deducted for depreciation in current and past years.

The Internal Revenue Commissioner (under the Act of 1909) ruled that depreciation, to be allowed, must be charged off as an expense on one side and credited to the Property Account on the other, although this disregarded the practice of most well-run concerns. The ruling was later rescinded and from May 9, 1912 it has been recognized that depreciation can be expressed on the

<sup>32</sup> (1902) 118 Iowa 234; 91 N.W. 108.

<sup>33</sup> (1909) 212 U.S. 13.

<sup>34</sup> Cf. Hatfield, H. R., *Accounting*, p. 136.

<sup>35</sup> H.R. 1438, p. 115. The Tariff Act of 1909.

<sup>36</sup> Internal Revenue Regulations, No. 31, Art. 4.

books of account by appropriate valuation reserve accounts.

The next appearance of the income tax was preceded by a constitutional amendment, the sixteenth, which became a part of the organic law in February, 1913, after more than three-fourths of the states had approved the change. On April 7, 1913, the income tax bill was introduced in the House of Representatives and on the 3rd day of October, 1913, the Underwood-Simmons Tariff Law, of which the income tax was a part, was approved and superseded the Payne-Aldrich Bill of 1909. The income tax applied to income which had accrued on and after the 1st day of March, 1913.

The law provided for depreciation as follows:

Section II B (individuals) That in computing net income for the purpose of normal tax there shall be allowed as deductions:

(sixth) a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business . . . .

Section II G (corporations) . . . .

(second) all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation by use, wear and tear of property, if any . . . .<sup>37</sup>

According to the plain import of these terms, an allowance for depreciation could be claimed only with respect to tangible property which was directly used in the production of the income taxed. The language of the act applied only to property which was "used" or "employed" in the business, and which, in the process of such use, was subject to "exhaustion," or "wear and tear." In this respect the law was stricter than the act of 1909. Also it is apparent that the law has not yet recognized obsolescence.

The regulations which set forth the Treasury's interpretation of the law were, in most cases, in accord with good accounting theory. The chief difficulty arose with the refusal, in many cases, of revenue inspectors to allow for both repairs and depreciation on

the grounds that the former included the latter.

The 1913 law provided that there should be a "reasonable allowance for wear and tear in use," and said nothing about how it should be shown on the books. As a consequence, firms as well as individuals claimed depreciation that was never recorded in their accounts. Because of this practice it was found necessary to dispatch a letter to the agents explaining the policy of the Treasury with respect to this practice. Briefly stated it explained that a depreciation deduction in order to be allowable must be a fair measure of the loss sustained and must be so entered on the books as to constitute a liability against the assets of the concern or individual. It is true that a mere non-entry cannot serve to negative a diminution of value yet such a penalty of non-allowance does force the recognition of depreciation upon the books. Although the policy did not conform strictly to the law, it was reasonable from the standpoint of correct accounting.

The Bureau of Internal Revenue went a step further and provided that a reserve for depreciation<sup>38</sup> could be used only for the purposes for which it was created and nothing else. Willard H. Lawton, C.P.A., took exception to this interpretation in a letter to the Commissioner which was answered as follows:

The only apparent reason for authorizing a deduction on account of depreciation is to provide a fund out of which the property with respect to which depreciation is claimed may be renewed or replaced, or to restore to the corporation the capital invested in such property when it is worn out or exhausted.

This does not mean that this fund should be locked up in a vault or that it cannot be used to meet the ordinary demands of the business, but that it should be available at any time to meet the purposes for which it was set aside.

. . . This fund should be carried as a separate and distinct account as a liability against the assets of the company.

<sup>38</sup> As stated above since May 9, 1912 the department has recognized the creation of a reserve as an alternative to a direct credit to the asset account.

<sup>37</sup> Act of 1913, Regulations 33.

The investment of this fund, or any part thereof in the company's own plant in the way of additions or extensions would appear to be a diversion of the fund to a purpose other than making good depreciation previously sustained. This may be permitted, however, if the property account is charged with the amount of the fund thus used, in which case the depreciation account remains a liability and renewals and replacements when made, are charged against it rather than against current income . . . .<sup>39</sup>

In effect this ruling said that the "fund" could be "diverted" provided that the expenditures thereof were not charged against the reserve for depreciation. As this accords with the general practice the point is only of historical interest.<sup>40</sup>

The law contemplated more than a mere renewal and repair reserve because it specifically permitted the deduction of "all ordinary and necessary expenses paid within the year in the maintenance and operation of its business and property . . .," as well as a "reasonable allowance for the exhaustion, wear and tear of property arising out of its employment or use in the trade or business." These are separate and distinct provisions, the first for necessary expenses including repairs, and the second for depreciation. Repairs could be deducted so long as they neither added to the value of the property nor appreciably prolonged its life but merely kept it in operating condition.<sup>41</sup>

Later Congress formulated the law of 1916. It provided an increase in the rates but left most of the provisions as they were in the Act of 1913. However the law did alter to some extent the provisions for depreciation. For individuals it provided:

Section 5 (a) . . . that in computing net income . . . there shall be allowed as deduction . . . (seventh) a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade. . . .<sup>42</sup>

The depreciation allowance for corporations was the same as Section 5 except that

the regulations added the further condition that deductions for losses would be limited to those actually sustained and charged off within the year on the books.

This addition to the section regulating corporations was simply a statutory recognition of past practices of the Treasury Department. The particular manner in which the amount was to be charged off was not material except that it must have been deducted from the book value of the asset or credited to a depreciation reserve account and reflected in the annual balance sheet.

Paragraph 484, Article 161, Regulations 33 (revised) provided that "the fact that no reserve was made for depreciation indicates that there is no loss on this account to be provided for." As far as taxation is concerned this may be a proper provision, but very improper from the standpoint of accounting. Accountants advocate an appropriate reserve or a reduction in the asset value but of course the mere book entry does not make more or less the actual depreciation which is continually going on. In many cases the Department takes the position that book entries are subordinate to facts, but here it is making the facts subordinate to the book entry.

This statute was amended the next year by the law of 1917, passed October 3. However this act made no appreciable changes in the allowances except insofar as there may have been adjustments made for the purposes of the Excess Profits Tax. The discussion of this phase of the act will be deferred until the policy of the Treasury is more clearly outlined:

The Act of 1918 made one notable change in the prior law.

Law: Sec. 214 (a-8) Individuals; Sec. 234 (a-7) Corporations:

That in computing the net income there shall be allowed as deductions:

A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business including a reasonable allowance for obsolescence.

Prior to this act the Treasury allowed realized obsolescence, i.e., it was necessary to dispose of the property before the loss

<sup>39</sup> Quoted in R. H. Montgomery, *Income Tax Procedure, 1917*, p. 209.

<sup>40</sup> *Ibid.*, p. 210.

<sup>41</sup> Article 131, Regulations 33.

<sup>42</sup> Regulations 33.

could be deducted for the purposes of arriving at the taxable income. Since such deductions could have been made as losses whether or not obsolescence as such was specified, the obvious intent of the 1918 law was to permit the accrual of obsolescence "so as to allow for such future obsolescence as may be expected from experience to result from the normal progress of the arts."

Accountants and bankers had for some time urged business men to provide ample reserves for future contingencies such as obsolescence even though the Treasury would not allow such as deductions. As a result these reserves were upon the books of the concerns when the law became effective. By returning the obsolescence reserves to the surplus account and restating the assets, the full obsolescence could finally be accrued for tax purposes as a part of depreciation. Instead of providing for it when first recognized, the recognition was in effect deferred until January 1, 1918 and thus the taxable income for the remainder of the life of the asset becoming obsolete would be reduced by the accruals from that date forward. As a means of reducing the taxes it was a fine scheme but not good accounting theory.

The general provisions in the regulations which set forth the conditions precedent to the allowances for depreciation read as follows:

Art. 161. Reg. 45; A reasonable allowance for the exhaustion, wear and tear and obsolescence of property used in the trade or business may be deducted from the gross income. For convenience such allowance will be referred to as covering depreciation, excluding from the term any idea of a mere reduction in the market value not resulting from exhaustion, wear and tear and obsolescence. The proper allowance for such depreciation . . . is the amount which should be set aside for the taxable year in accordance with a consistent plan by which the aggregate of such amounts for the useful life of the property in the business will suffice, with the salvage value, at the end of such useful life to provide in the place of the property its cost, or its value as of March 1, 1913, if acquired by the taxpayer before that date.

Here for the first time salvage value is recognized and although the regulations did

not prescribe a method of charging off depreciation, they did provide that the write-off should be "in accordance with a consistent plan."

This regulation also introduced for the first time the idea of a March 1, 1913 value. Prior to this, Treasury Decision 2745 had provided the same basis. Formerly the policy of the Treasury was that the value to be cared for by depreciation was the actual amount invested in the property and not some value which might be arbitrarily fixed. The introduction of this rule (T.D. 2745 or Art. 161, Reg. 45) departed somewhat from the usual accounting procedure because of the establishment of an arbitrary base for purposes of computing the allowance for depreciation. In many cases the depreciation for income tax purposes on this prescribed base would be greater than the charges considered from the point of view of the reduction of the original investment. This would occur if the March 1, 1913 value was in excess of the book figure. The reverse is also true. If the book figure was larger than the arbitrary value then the charges for income tax purposes would be less than the charges to reduce the original investment over the life of the asset.

The law said nothing about using income tax depreciation for the charge-off entry on the books. However in other sections of the law the Commissioner was given ample opportunity to enforce proper accounting methods. He made use of those sections to require a charge-off on the books for depreciation claimed in the returns.

The regulations and that section of the 1918 act relating to accounting procedure would seem to imply that only those charges for depreciation which were applicable to the then current year could be deducted in that year. A letter to the revenue agents reads as follows:

Ruling: The statute is not, however, to be construed as requiring that depreciation, depletion, and other losses be charged off within the taxable year. It is sufficient that they be charged off before they are allowed as deductions. . . . If the books of the corporation are re-opened for the purposes of charging off depreciation, depletion,

or other losses, corresponding corrections must be made in other book entries; and if for any reason the facts do not warrant such other charges, depreciation, depletion and other losses cannot be charged off, and, therefore, cannot be allowed as deductions. Thus, for example, if by reason of a distribution of earnings there is nothing from which to credit a reserve for depreciation no allowance for depreciation can be credited to a depreciation reserve account.<sup>43</sup>

The last sentence does not accord with accounting theory. Regardless of whether or not an excessive distribution of earnings has been made in any one year during which no depreciation has been charged, depreciation must be included in the restatement of accounts if the accounts are to be correctly stated.

The regulations provided further that where the useful life of an asset has been underestimated or the deterioration overestimated, the rate applicable to future years could be reduced. The readjustment is not made through amended returns but rather through amended rates for the years of life remaining to the property. It would seem that the converse of this would be true, i.e., if the life of the property was overestimated, the rate of depreciation should be increased sufficiently during the remaining years of the asset's life to recover the cost.

Due to the insistence of business men that the taxes imposed by the 1918 law were unduly burdensome and not fitted for post-war conditions, both political parties in the campaign of 1920 pledged themselves to a revision of the law. The Act of 1921, passed on November 23 of that year, was the result of the pledge made by the Republican party. Although the law emerged from the House of Representatives in the form of a series of amendments, it was a complete new act when it finally came from Congress. However it follows its predecessor so closely that it may be described as a rewritten draft of the prior statute.

With respect to depreciation, the law now provided that:

<sup>43</sup> Quoted in R. H. Montgomery, *Income Tax Procedure, 1920*, pp. 695-96.

Sec. 214 (a-8) Individuals and Sec. 234 (a-7) Corporations . . . in computing net income there shall be allowed as deductions:

A reasonable allowance for the exhaustion, wear and tear of property used in the business, including a reasonable allowance for obsolescence. In the case of such property acquired prior to March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913 . . .

The law thus incorporated the practice of T.D. 2754. In an opinion rendered by the Solicitor of the Bureau of Internal Revenue, it was held that this decision was applicable to returns for 1913 and all subsequent years.<sup>44</sup>

Bulletin "F" issued by the Bureau of Internal Revenue summed up much of the law with respect to depreciation and obsolescence. In this bulletin there were only two methods favored by the Treasury, but it was made clear that the Treasury would be willing to approve other methods if they were found to be more accurate. Those specifically mentioned were the "fixed percentage" and the "production" methods.

Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. While the burden of proof rested upon the taxpayer to sustain the deduction taken by him, a deduction could not be disallowed unless shown by clear and convincing evidence to be unreasonable, the reasonableness to be determined by the conditions known to exist at the end of the period for which the return was made.<sup>45</sup>

The entrance of the United States into the World War created another problem, similar in every respect to that faced by other countries. The nation needed war materials and the capacity to produce was sorely lacking. As a consequence, in a period of rapidly rising prices, production capacity was greatly increased to supply the war needs. When the war came to an end manu-

<sup>44</sup> R. H. Montgomery, *Income Tax Procedure, 1922*, p. 19, quoting from Bulletin "F," Depreciation and Obsolescence.

<sup>45</sup> Regulations 62, Art. 165.

facturers found themselves with excess plant capacity little of which they could expect to use again. Recognizing that there was a vast amount of plant machinery, etc., used for war purposes which now had little or no residual value, the laws in 1918 permitted the amortization of a reasonable amount of the cost of such property.

No part of the income tax procedure has been more prolific in producing different regulations than amortization. The first set was issued shortly after the passage of the 1918 law and merely reflected the wording of the law. The regulations issued in 1919 attempted to narrow the scope of the deductions, the Treasury evidently considering that the early regulations were too liberal. Next came T.D. 3123 (issued January 28, 1921) which recognized that the amortization deductions, instead of being allocated entirely to 1918 and 1919, might be extended to a subsequent date. The fourth set was included in the 1921 law. No detailed explanation of the deductions permitted under the various sets of regulations will be attempted here. The major changes and the theory underlying the amortization principle will be sufficient to provide a summary of this phase of the law.

The 1916 law allowed only ordinary depreciation due to exhaustion, wear and tear, and did not consider amortization or obsolescence.<sup>46</sup> The Revenue Act of 1918 however provided, (a) that in the case of buildings, machinery, and equipment or other facilities constructed, erected, installed or acquired on or after April 6, 1917, for the production of articles contributing to the prosecution of the war with Germany, and (b) that in the case of vessels constructed or acquired on or after April, 6, 1917, for the transportation of articles or men contributing to the prosecution of the war with Germany, there shall be allowed a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, this sum might not again include any amount otherwise allowed under the Revenue Act of 1918 or

previous laws as a deduction in computing net income.

The 1921 law contained the same provisions except that the deductions were allowed "for any taxable year ending before March 3, 1924 (if claim was made at the time of filing returns for the taxable years of 1918, 1919, 1920 or 1921)," and the words "before March 31, 1924" were inserted in place of the words "within three years after the termination of the present war."<sup>47</sup>

The administration of this allowance was more difficult than the law indicates. The fundamental theory of the amortization principle is that the taxpayer, who, in connection with the war made expenditures for property more or less useless to him in his ordinary business and which he would not otherwise have acquired at the high prices prevalent during the war, should not suffer from the necessity of paying taxes upon income resulting from the production out of property thus acquired at inflated prices. The theory embodied in the statute was that this extraordinary depreciation or obsolescence should be spread somewhat differently than the conventional method of distributing the depreciation allowance over the life of the property; that is, this extraordinary depreciation or obsolescence should be allocated to the years of high income.

The law of 1921 was not ambiguous. The chief difficulty came from the conditions laid down in the Treasury regulations which were altered three times before the passage of the 1921 law.

The successive steps for amortizing extraordinary obsolescence under the 1921 law may be summarized as follows:

(a) Statement of facilities to be amortized must show that they were constructed, erected, installed or acquired on or after April 6, 1917.

(b) The facilities in (a) must have been for the "production of articles contributing to the prosecution of the war."

(c) Classification of the facilities under (a) into the following: (1) Sold or discarded,

<sup>46</sup> Letter from the Treasury Department dated January 14, 1919.

<sup>47</sup> Revenue Act of 1921, Sec. 214 (a-9); Sec. 234 (a-8) and the same sections of the Revenue Act of 1918.

or which will be sold or discarded before March 3, 1924. (2) Retained as part of the taxpayer's going business.

(d) Valuation of the property in (c). (1) Items in (c-1) are taken at actual sale price, or at estimated fair market value at date property will be sold or discarded. (2) Items in (c-2) are taken at estimated "value in use" to the taxpayer.

(e) Cost (after depreciation, losses, etc., prior to January 1, 1918) less value in (d) will give the total amortization deduction which will be spread over

(f) The amortization period, divided as follows: (1) For property in (c-1): "Between January 1, 1918 and the date when the property was or will be sold or permanently discarded as a war facility" (Art. 185). (2) For property in (c-2): "Between January 1, 1918 and the actual or estimated date of cessation of operations as a war facility" (Art. 185).

(g) The amortization deduction (e), separately computed as to the two classes of property in (c), is spread over the amortization period (f), having reasonable regard for the gross and net income for each of the years in the amortization period, and, where separately ascertainable, the income from the facilities upon which the amortization is claimed. When there are both classes of property, *i.e.*, (c-1) and (c-2), to be considered, the amortization period must be computed separately for each class of property.<sup>48</sup>

Prior to the law of 1921, the regulations contained the clause, "Depreciation for any taxable year after December 31, 1917 should, therefore, not be claimed with respect to property as to which an allowance for amortization is claimed." In many instances the taxpayers were led to believe that the unamortized balance of property with respect to which allowance had been claimed in 1918 and 1919 returns was not subject to a claim for depreciation. The new regulations (1921) omitted the above clause and it was no longer doubted that deprecia-

tion could be claimed on this balance just as on any other depreciable property. The balance would be the "value in use" as finally determined.

The law imposed no limitation on the amount of amortization to be deducted in any one year nor did it state that the entire amortization must be claimed against one year's income. The intent of the law seemed to permit those entitled to such an allowance to write-off, as quickly as possible, the excess cost of such plants over normal or pre-war cost and to apply such write-offs in the reduction of income reported for taxation in subsequent years.

The only portion of the Excess Profits Tax of interest in this study is the effect of depreciation on the determination of invested capital.

For the purpose of the Excess Profits Tax, invested capital included the following:

(1) Actual cash paid in for stock or shares.

(2) Actual cash value of tangible property, other than cash, paid in for stock or shares, irrespective of the par value of the stock. If the cash value is shown to be in excess of such par value it will be treated as paid-in surplus

(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year,

(4) Intangible property (patents, copyrights, secret processes, formulas, goodwill, trade marks, franchises and the like) paid in for stock or shares to an amount not to exceed: (a) actual cash value at the time paid in, (b) the par of the stock issued therefor, or (c) 25% of the par value of the outstanding shares of stock on March 3, 1917, in respect of all intangible property paid in prior to that date and 25% of the par value of the stock outstanding at the beginning of the taxable year in respect of all intangible property acquired after March 3, 1917.<sup>49</sup>

Invested capital was thus the capital actually paid in to the corporation by the stockholders, including the surplus and undivided profits, and was not based upon the then present net worth of the assets de-

<sup>48</sup> Adopted from R. H. Montgomery, *Income Tax Procedure, 1923*, pp. 1093-94.

<sup>49</sup> Sec. 236(a). Reg. 62, 1922 ed.

terminated by an appraisal or any other method.

It will be recalled that the British determined invested capital from the asset side of the balance sheet, excluding written-off depreciation from the computation. In the United States the sum originally invested constituted the irreducible minimum and was determined from the liability side of the statement. However in both cases the determination of the "proprietor's capital" was the fundamental concern of the law-makers.

The accounting for depreciation had two effects upon the accounting for the Excess Profits Tax. First, the laws permitted the restoration to surplus account of any excessive depreciation charged off (with contra credit either to the property or the depreciation reserve account) on property still owned and in use. The same is true of those assets purchased and charged against the earnings of the period when they were acquired. This adjustment to the surplus account would increase the amount of invested capital and result in a larger credit against the earnings of the enterprise and thus reduce the amount of taxes to be paid. Second, by the above adjustment the book value of the property would be increased and thus afforded a larger property base upon which subsequent allowances would be computed.

The above adjustments to the surplus account were not easy to apply. The books of the concern were presumed to show the facts and if a claim was made that its surplus was understated, the burden of proof rested upon the taxpayer. Office Decision 1104 in speaking of this matter said in part:

A presumption should always exist that the taxpayer's books of account reflect actual facts. The burden of proof is upon anyone who attempts to impugn the correctness of the books of account—upon the government if it seeks to reduce the surplus account by charging off depreciation which has not been claimed by the taxpayer, and upon the taxpayer where he claims that too much depreciation has been charged off in prior years.

Returning to depreciation in the income tax proper, the most important change in

the 1924 law is found in the following new provision:

Law: Sec. 204 . . . (c) The basis upon which depletion, exhaustion, wear and tear and obsolescence are to be allowed in respect of any property shall be the same as is provided in subsection (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of property. . . .

The basis provided in Section 204(a) is cost and is concerned with property acquired after February 28, 1913. The basis provided in Section 204(b) is cost or value at March 1, 1913, whichever is greater, and refers to property acquired prior to March 1, 1913. Previously the Treasury allowed depreciation on March 1, 1913 value only, even when cost was greater. In that case the taxpayer would not be permitted to charge off the full original cost of the asset. Thus certain inequities were now corrected by allowing depreciation on the greater of cost or market value. The insertion of an arbitrary value is usually contrary to accounting principles. Nevertheless, this insertion enables the taxpayer to recover at least cost in all cases and thus conforms more closely to the general purpose of accounting.

The provisions of the laws of 1918 and 1921 permitting deductions for amortization of war facilities were not re-enacted in the 1924 law, although not all amortization claims had been settled and claims with respect to return of prior years could still be filed.

Contrary to the practice in England, the Treasury Department found it inadvisable prior to 1926 to prescribe definite rates for specific classes of assets. During that year however the Commissioner initiated a study with a view to the establishment of agreed fixed rates of depreciation. Before this date the Commissioner and representatives of several industries had agreed upon rates as reasonable for major items of plant and equipment used in the businesses of the representatives. The purpose of the 1926 study was to extend similar agreements to the taxpayers of other industries. An average rate was to be determined, subject to the approval or disapproval of the taxpayers, and

this average rate was to be acceptable as reasonable at all times and for any purpose by the Commissioner. There were also to be adopted maximum and minimum rates for depreciation, or for combined depreciation and maintenance charges, within which range the taxpayer would select a specific rate to be consistently applied. However these rates were not to be rigid. If upon affirmative evidence the taxpayer could prove peculiar circumstances in his operations, the selection of a rate above the maximum or below the minimum would not be prohibited. A continued study of this kind certainly holds promise of yielding valuable results both in expediting the audit of returns and the establishment of a norm by which the taxpayer may judge his claims.

In a definition advanced in 1931, depreciation was said to be the gradual exhaustion, wear and tear of property through use in the trade or business, including normal obsolescence.<sup>50</sup> Obsolescence was in turn defined as the "process of becoming obsolete, brought about by the progress of the arts and sciences, changed economic conditions, legislation, or otherwise, whereby it can be predicted with reasonable accuracy that property used in the trade or business will be useless at a definite date in the future prior to the expiration of the normal useful life of the property."<sup>51</sup>

The Bureau does not ordinarily approve composite rates and while the regulations clearly indicate that the item basis for computing depreciation is largely desirable from an income tax standpoint, practical accounting limitations are recognized and the so-called unit-rate basis is approved where a reasonable showing is made of the correctness of the figures submitted. This basis applies average rates to groups of assets determined to have similarity of useful life.

Treasury Decision 4422 and Mimeograph number 4170 completely overshadow the act of 1932 and serve as the basis for changes in the Act of 1934. Due to the widespread interest shown by business men, accountants,

and lawyers in this ruling, the events leading up to the ruling and the ruling itself will be examined.

First in the events preceding the installation of the new Treasury policy we find the Sub-Committee of the House Committee on Ways and Means stating in its report on December 3, 1933, that depreciation deductions had been increasing for years. The report also set forth statistics purporting to show that in 1930, in the case of corporations reporting net income, the depreciation deduction amounted to 28.2% of the income before the deduction.<sup>52</sup> The Sub-Committee therefore recommended that a flat reduction of 25% be made in depreciation allowances which would have been allowable in 1934, 1935 and 1936, estimating a resulting increase of \$85,000,000 in revenue. This flat reduction was opposed by Secretary of the Treasury Morgenthau,<sup>53</sup> who offered a substitute measure in the form of a plan to reduce these allowances by administrative action. The substitute was embodied in a letter to the Sub-Committee and said in part:

It is intended that this shall be accomplished, first, by requiring taxpayers to furnish detailed schedules of depreciation containing all the facts necessary to a proper determination of depreciation; second, by specifically requiring that all deductions for depreciation shall be limited to such an amount as may reasonably be considered necessary to recover during the remaining useful life of the asset the unrecovered basis of the asset; and third, by amending the Treasury Regulations to place the burden of sustaining the deduction squarely upon the taxpayers so that it will be no longer necessary for the Bureau to show by clear and convincing evidence that the taxpayer's deductions are unreasonable. These changes will increase the revenue greatly and records indicate that it will approximate that which would result from the other proposal. . . .

Recognizing the fairness of the position taken by the Department and relying on

<sup>52</sup> This is based upon figures from the private files of the Secretary of Treasury. None of these however were made public.

<sup>53</sup> This stand was taken after the Treasury Department assured him the same results could be obtained in another way which would not run the risk of being declared "illegal."

<sup>50</sup> Bulletin "F" Depreciation and Obsolescence, 1931. United States Printing Office, p. 2.

<sup>51</sup> *Ibid.*, p. 3.

the assurance of proper administration, Congress refrained from making any statutory changes affecting depreciation deductions.

The Treasury Department lost no time in making good its promise. On February 28, 1934, T.D. 422 was promulgated, amending Art. 205 of Regulations 77 and 74, and Art. 165 of Regulations, 69, 65, and 62, *i.e.*, back to and including the Act of 1921. The amendments carried out the points in the letter quoted above.

The change in the Treasury policy can best be shown in a comparison of Article 23(1)-5 of Regulation 86 (Act of 1934 with Article 205 of Regulation 77 (Act of 1932) as the latter stood before amendment by T.D. 4422.

The following sentence was eliminated from Regulation 77 (Art. 205): "If it develop that the useful life of a property will be longer or shorter than the useful life as originally estimated under the then known facts, the portion of the cost or other basis of the property not already provided for through depreciation allowances determined in accordance with the useful life of the property as originally estimated, should be spread over the remaining useful life of the property as re-estimated in the light of subsequent facts, and depreciation deductions taken accordingly." Also eliminated was the sentence, "While the burden of proof must rest upon the taxpayer to sustain the deduction taken by him, such deductions will not be disallowed unless shown by clear and convincing evidence to be unreasonable." In lieu of this latter sentence there was substituted the following: "The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, taxpayers must furnish full and complete information with respect to the cost of other basis of the assets in respect of which depreciation is claimed, their age, condition and remaining useful life, the portion of their cost or other basis which has been recovered through depreciation allowance for prior taxable years, and such other information as the Commissioner may require in substantiation of the deduction claimed. . . ."<sup>44</sup>

<sup>44</sup> Art. 23(e)-5, Regulation 86.

The wording of later rulings would seem to indicate that the provisions of T.D. 4422 were to be administered with the least possible effort and expense on the part of the taxpayer; with this end in view three classes of taxpayers were not required to file information (unless requested) in respect to deductions in the past and present. The classes are as follows: (1) those taxpayers whose returns show net losses after appropriate adjustments, (2) those taxpayers whose returns indicate clearly that only reasonable amounts of depreciation have been claimed, and (3) those taxpayers whose returns indicate that the depreciation deduction is a very minor factor.

It is difficult to indicate with any degree of certainty the extent to which the Treasury Decision was made for the sole purpose of increasing government revenues. Some portions of the Treasury Decision would lead one to believe that the Bureau was attempting to eliminate only the practice of writing off depreciation at an excessive rate and carrying the asset as one fully depreciated though still in use. Even if this was the intention of the Treasury, it must be noted that the Treasury would have received all the revenue that was payable to it under the law through the tax upon the increased income of those later years in which no depreciation could be deducted. The basis was thus suddenly changed to "unrecovered cost," *i.e.*, the remaining value would be spread over the remaining life of the asset estimated in the light of present events. The collection of revenue would be increased in the present when the money was needed, or rather wanted by the government, instead of in future years.

The apportionment of the unrecovered cost over the remaining years of useful life is eminently sound from a tax standpoint. From the standpoint of commercial accounting, retroactive adjustments through surplus are preferable. The Treasury policy is simply a continuation of the procedure followed for years with respect to revisions of estimated depreciation.

Obviously those taxpayers whose depreciation deductions are clearly excessive and

unreasonable will be compelled by T.D. 4422 to reduce their claims with a subsequent increase in the income tax to be paid in the now-open years. Those taxpayers whose deductions have been reasonable have nothing to fear unless the Treasury alters its present stand by doing what it failed to do in 1934—that is by making a flat reduction in all rates.

Having reviewed the history of depreciation in the income tax practice of England and the United States, we are now in a position to raise three distinct questions: (1) what has been the effect of the laws of one country upon the other, (2) what has been the effect of the laws upon accounting theory and practice, and (3) what influence has accounting theory and practice exercised upon the laws?

Great Britain began her income tax late in the eighteenth century, United States approximately seventy-five years later. The tax laws in both cases were the result of emergency conditions and were looked upon as temporary measures. But in both countries they have become very important units in the respective fiscal system and there is every indication that they will so remain.

Strange as it may seem neither the legislative bodies of Great Britain nor of the United States have cared to pay much attention to each other. Due to the differences in the concept of income, in the temperament of the people and in constitutional limitations, the laws have developed along quite different lines in both countries.

In dealing with the income from business, professions, etc., the British law starts with a conception of the actual profits, *i.e.*, the net profits. The law does not set out allowable deductions from gross profits but contents itself with specifying deductions that may not be made. The American law on the other hand first outlines what may be included in gross profits. Next follows a list of items which are not to be included because of exemption from the income tax. Then are set forth deductions which may be made from gross in arriving at net profits and certain changes which are not so deductible.

The net income figure thus ascertained is the amount subject to the tax.

The people of the two countries have been vital factors in the writing of the respective laws. The natural conservatism of the English people reflects itself in the law. Since 1842<sup>55</sup> there have been few changes. It is true that the British have passed Finance Acts yearly since that time but for the most part they have been concerned only with the renewal of the past measures and the establishment of rates for the year to which the Act applies. Changes are made slowly. This is easily shown in the case of obsolescence, although allowed in some cases "in practice" in 1897 it was not until the Customs and Inland Revenue Act of 1918 that it was written into the law itself.

In the United States the "trial and error" method has been emphasized. On the spur of the moment a change has been made and if it was found that it worked its retention was assured; if it failed, another plan was tried. Each law has been radically different from its predecessor.

With respect to depreciation and obsolescence the two laws are quite divergent. In England a narrow interpretation is placed upon the allowance for depreciation while in the United States the latitude allowed is quite remarkable. Only one explanation is possible. The wide development of accounting came after the inception of the income tax in Great Britain and the theory of depreciation as it is understood today was therefore not known to the makers of the law. With the firms failing to recognize such a cost it is to be expected that Parliament would not include provision for such charges when they wrote the statutes.

The establishment of rates through conferences between the British government and the taxpayers antedated the same procedure in the United States by several years. It is logical to believe that the success of the British with this scheme might have been a prime factor in causing the adoption of the same policy in this country.

The present plan of the United States is

<sup>55</sup> Or earlier, for the Act of 1842 was copied from previous laws.

evidently to study the experience of England. Pursuant to this policy a committee headed by Roswell Magill acting under the instruction of the Joint Committee of Internal Revenue Taxation of the United States Congress, recently visited England to study the income tax laws and their administration. A complete summation of their findings was prepared for the information of Congress.<sup>66</sup> What use will be made of this summary is problematical, but no doubt an attempt will be made to adopt some of the British practices in future income tax laws of this country. The conditions in the two countries are not identical and there must be a wide difference in the taxation programs, but fundamentally the same principles could be common to both nations.

In regard to the non-revenue effects of the American laws, it has been said:

The income tax regulations have no doubt been more potent in bringing about this condition [the general recognition of depreciation] than the admonitions of the accountants or the arguments of the academicians.<sup>67</sup>

At that time [1908] any recognition of depreciation was relatively uncommon in the accounts of American corporations, and the relatively few companies which showed depreciation in prosperous years grew fainthearted when the business was poor. But an examination of the balance sheets of corporations during the trying period after the World War shows that many of them made charges for depreciation even though that resulted in a net deficit. This closer adherence to correct accounting principles was doubtless stimulated by the provisions of the income tax law.<sup>68</sup>

Business men of the older generation were apt to look upon depreciation as a matter of accounting theory which they might adopt or ignore according to their individual wishes. Prior to the advent of these laws no amount of moral suasion or logical argument could bring these many corporation officials to the point of making adequate allowances in their accounts for depreciation. The same result is found in England where the reports

of the Exchequer show that the amount of income exempted on account of wear and tear rose from £4,000,000 in 1893-4 to £12,750,000 in 1902-3 although the law was not changed in any one of the intervening years.

In many instances the regulations employed well-established accounting principles and methods in definitely outlining the procedure to be followed. These principles were literally forced upon the business world and methods were brought into use almost overnight which otherwise would have been neglected for years.

One of the most beneficial results of the income tax was that it brought to the attention of the taxpayers the necessity of keeping accurate records. The government has immensely strengthened the accountant's long maintained position that the book of account should show all the facts, and that, when it is found necessary to re-estimate values, the manner and amount of such estimates should be clearly written into the accounting history of the enterprise.

In both the United States and Great Britain, the most commonly accepted method of computing depreciation in practice is that sanctioned by the laws in the respective countries. In England the reducing balance method is the only one sanctioned (except in the case of ships); it is used in the accounting procedure as a matter of course. One English authority states with respect to this, "It may be considered as regrettable that this circumstance should be allowed to affect the operation of the accounting science."<sup>69</sup>

Prior to the introduction of the income tax in the United States, it was quite usual for depreciation to be calculated on the declining value of the asset. However, since the Treasury Department has consistently recommended the straight-line method (except in extraordinary cases) the declining value method has almost entirely disappeared from practice. Accountants have accepted the straight-line method based upon cost as the most practical.

<sup>66</sup> Magill, R., *Summary of the British Tax System*, U.S. Printing Office, 1935.

<sup>67</sup> *Accountants' Handbook*, Second Edition, p. 578.

<sup>68</sup> Hatfield, H. R., *Accounting, Its Principles and Problems*, p. 140.

<sup>69</sup> Rowland, S. W., *Accounting*, p. 299.

Undoubtedly the knowledge of the accountants, in respect to depreciation, obsolescence, and amortization, has been considerably broadened as a result of the arguments advanced by the Treasury Department. The handling of tax cases before the Board of Tax Appeals has also necessitated the preparation of the cases upon principles that would stand the test of a court hearing.

In speaking of the effect of the income tax upon accounting, one writer has said:

Through it and particularly through the thorough work of the accountants in connection with it, old ideas of primitive accounting are passing out of business and new and valuable ideas are coming in.<sup>60</sup>

While the regulations and rulings of the Bureau of Internal Revenue are bound to exercise a marked influence on the development of accounting procedure, the fundamental accounting principles are not likely to be seriously disturbed by any action of the Treasury Department.

In the construction and application of the first income tax law, the fundamental task of Congress and the Treasury Department was the establishment of rules and procedures to govern the determination of profit or loss. The American law makers turned to accounting for the principles by which income should be determined. This was not thoroughly done in England. The fact that accounting developed from bookkeeping after England began her income tax may partly explain this fact. The writer does not wish to go on record as saying that these law-makers did not turn to accounting, (or to bookkeeping, as it may perhaps more properly be called at that early date). However it is clear that the profession was better developed when the United States began its income tax with the law of 1909; the influence of professional ideas and practices upon the statutes were therefore more marked than would have been had our laws been framed earlier.

Throughout the history of the British Income Tax, the activity of the accountant

is also quite noticeable. It was an accountant (Mr. Chadwick) who was one of the most ardent supporters of the proposal for allowing "wear and tear" which was injected into the statutes in 1878. Accountants have testified before various committees and the committees have recommended changes in the law which would have brought the statutes more into accord with accounting principles. But for the most part these suggestions have not been incorporated into the British law.

The British practice of deducting, for income tax purposes, the depreciation allowance from the taxable profits after these have been reported by the taxpayer is not found in the laws of the United States. The reason for its appearance in the English law is no doubt found in the fact that when the "wear and tear" allowance was first introduced into the statutes it was the common practice of the companies to state the profits and then through an explanatory statement to note that this was the profit before depreciation and dividends. Even though this practice is not used by accountants at the present time the law still retains the feature. It is another case of the law of the land not keeping pace with the development of good accounting.

In the early days of the tax in this country one finds quotations such as the following:

It is now the duty of every public accountant, and of every client of an accountant, to vigorously protest against the administration of the law until its requirements are made to harmonize with the existing, well established accounting methods.<sup>61</sup>

The position thus taken by the accountants in the evolutionary period resulted in the correlation of theoretical and practical methods; in the end many valuable suggestions were incorporated into the income tax laws.

No more fitting tribute could be paid to those accountants who have striven for sound principles of accounting in income tax matters than that spoken by Charles D.

<sup>60</sup> Geo. Nutter at the 25th Anniversary Meeting of the Massachusetts Society of C.P.A.'s at Boston, April 27, 1925.

<sup>61</sup> From an address by Allen R. Foote before the American Association of Public Accountants in Denver, Colo., October 18-21, 1909.

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Hamel, former Chairman of the United States Board of Tax Appeals, when he said:

The important part played by the accountant in the administration of the law during these years has had its effect upon the principles involved in the more recent acts. The principles embodied in the present act are the result of knowledge obtained by the Treasury Department

through its administration of the law. Many of the most important changes are those founded upon sound principles of accountancy, many of which have gone into the regulations and subsequently became a part of the law itself.<sup>22</sup>

<sup>22</sup> Address delivered at the annual meeting of C.P.A.'s at Detroit, Mich., September 12, 1924. *The Certified Public Accountant*, Vol. 3, p. 273.

## TAXABILITY OF STOCK DIVIDENDS UNDER FEDERAL AND STATE LAWS

HARRY D. KERRIGAN

SHOULD stock dividends be considered income in hands of the recipient? No single issue involving economic, financial, accounting and social considerations has probably provoked so much discussion over so long a time as has this one. Views expressed on the subject are numerous and conflicting not only because different aspects of the problem are emphasized by different persons, but also because a given aspect itself has undergone change because of developments within the given field of thought or practice. The present discussion is limited to a review of the legal history of the problem insofar as it relates to the income-tax laws of both federal and state governments.<sup>1</sup>

### THE 1913 ACT AND TOWNE VS EISNER

Under the series of Federal income-tax laws since the sixteenth amendment was passed in 1913,<sup>2</sup> dividends have been subject

to tax in hands of the recipient.<sup>3</sup> The 1913

desirable at this point. The first American income-tax law was passed on August 5, 1861, as a revenue measure to help finance the Civil War. Before the Act went into effect, a second law was passed known as the Act of July 1, 1862. Taxes were to be levied under the latter law beginning with 1863, and were to be in force for four years. Two later Acts, one as of March 3, 1863 and another one as of June 30, 1864, continued the tax until the close of 1872, when the last Act expired. After a lapse of twenty-two years, a federal income tax was reimposed in 1894 under the Revenue Act of 1894, which was to have become effective August 28, 1894. This law, however, was never enforced. It was declared unconstitutional in the famous case of *Pollock v. Farmers' Loan and Trust Co.* (157 U.S. 429; 158 U.S. 601), decided on May 20, 1895. The court's grounds for unconstitutionality were that (1) a tax on income is in substance a tax on the source thereof, (2) a tax on property, real or personal, is a direct tax, and hence (3) a tax on the income from property is a direct tax, which, under the constitution, may not be levied without apportionment among the several states according to population (Constitution, Art. 1, sec. 9, cl. 4).

The Pollock decision started a movement for a constitutional amendment to permit the taxation of incomes by the Federal Government. The movement culminated in the adoption in 1913 of the sixteenth amendment, which reads as follows: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration." An interesting interlude between the 1894 Act and the first law under the authority of the Sixteenth Amendment took place in the form of the Corporation Excise Tax of 1909, enacted August 5, 1909. This Act imposed on corporations an excise tax, measured by net income, for the "privilege" of doing business. The constitutionality of the law was upheld in *Flint v. Stoney-Tracy Co.* (220 U.S. 107), decided on March 13, 1911. Though held by the court not to be an income tax and therefore not a direct tax within the meaning of the Constitution, the Act may nevertheless be regarded as a forerunner of the income-tax measures which were to follow. The 1909 law remained in force until the effective date of the Revenue Act of 1913.

<sup>3</sup> Individuals were allowed, in the Acts prior to 1936,

<sup>1</sup> A related problem, not treated here, is the determination of the amount of taxable gain when either the dividend shares or the shares upon which the dividend was received is sold.

As to the Federal law, see sec. 113, 1934 Act, (48 stat. 706-9), and regulations thereunder, Reg. 86, art. 22(a) (8), art. 113(a) (12) (1). See also sec. 113, 1936 Act. For discussions of the problem see Comment (1934) 12 N.Y.U.L.Q. Rev. 283; Meggs, D. B., Computation of Income (1924) 13 Calif. Law Rev. 13; Klein, J. J., Federal Income Taxation (1929) 856-59; Montgomery, R. H., Fed. Tax Handbook (1934), pp. 190-96, 1927 Edition, 453-58.

As to the state income-tax laws, see provisions bearing on the point in the individual state statutes.

<sup>2</sup> The sixteenth amendment authorized the enactment of a Federal Income Tax. A brief history of the events leading to the passage of this amendment is

Act contained no mention of stock dividends, but the Bureau of Internal Revenue interpreted the law to include stock dividends as income<sup>4</sup> and hence subject to tax. This interpretation was questioned by a taxpayer, H. R. Towne, who carried the case to the United States Supreme Court.<sup>5</sup> The court decided in favor of the taxpayer, declaring that stock dividends were not tax-

to exclude dividends received from income for purposes of the normal tax, but were required to include such dividends in computing surtax (e.g. 1934 Act, sec. 25(a) (1) (48 Stat. 69)). Under the 1936 Act, however, such dividends must be included in computing normal tax. As to corporations, from 1916 to 1934, inclusive, dividends received from a domestic corporation subject to the tax were allowed to be excluded from income for purpose of the tax (e.g. 1934 Act, sec. 23 (p) (48 Stat. 690)). Under the 1935 law, this exemption was reduced to 90% of the amount so received (Sec. 102(h), (40 Stat. 1016)), while under the 1936 law the exemption was further reduced to 85% of the amount received (Sec. 26(b)). Moreover, under the new dual (1) normal tax on net income and (2) surtax on undistributed net income, the credit allowed against net income for dividends received, in computing normal tax, is not available in computing surtax.

The principle behind the exemption of dividends received from income subject to normal tax is avoidance of double taxation on the theory that the corporation itself paid a tax on the income before any part of it became available for dividend distribution. The legislative trend seems definitely to pay less attention to this principle.

<sup>4</sup> The department at first noted that such dividends were not subject to tax (T.D. 2163, Feb. 18, 1915):

"Stock dividends issued as a *bona fide* and permanent increase of the capital stock of corporations . . . without intent to evade the imposition of the personal income tax, are held to represent capital; and are not subject therefore to the income tax as gains, profits and income in the hands of stockholders."

The Department later reversed its position and held stock dividends taxable (T.D. 2274, Dec. 22, 1915):

"Stock Dividends paid from the net earnings or the established surplus or undivided profits of corporations . . . are held to be the equivalent of cash, and to constitute taxable income under the same conditions as cash dividends."

<sup>5</sup> *Towne v. Eisner*, 245 U.S. 418, decided January 7, 1918. The reported facts of this case were as follows: The corporation declared a dividend on Dec. 17, 1913, in the amount of \$1,500,000 from earnings made prior to January 1, 1913, payable in the form of new stock, par value \$100 per share. Towne received 4,174 $\frac{1}{2}$  shares which represented his pro rata proportion of the dividend stock. The Revenue Department assessed a tax on this stock as equivalent to \$417,450 income in cash. Towne paid the tax under protest and sued to recover. The lower court (242 F.702 (1917)) held Towne was liable for the tax on a sum equal to the par value of the dividend stock received because it was income within the Act of 1913. The case was then appealed by Towne on the ground that the 1913 Act so construed was unconstitutional.

able as income<sup>6</sup> under the Act. In support of its decision, the court said:<sup>7</sup>

A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interest of the shareholders. Its property is not diminished and their interests are not increased. . . . The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones. . . . In short, the corporation is no poorer and the stockholder is no richer than they were before. . . . What has happened is that the plaintiff's old certificates have been split up<sup>8</sup> in effect and have diminished in value to the extent of the value of the new."

The significance of the foregoing decision was restricted by several facts peculiar to the case. (1) The court relied for authority upon *Gibbons vs. Mahon*, decided in 1890, which held stock dividends to represent capital interest for purposes of distribution between life tenant and remainderman.<sup>9</sup> (2) The profits in question were earned prior to January 1, 1913.<sup>10</sup> (3) The Act under which the

<sup>6</sup> Thus in this the first case in which the question of stock dividends as taxable income was raised, the court emphasized the distinction between capital and income, and held that dividend stock represents capital, not income, and that a tax on the former is a direct tax which is unconstitutional unless levied by apportionment. This point is discussed further in connection with *Eisner v. Macomber* in the next section.

<sup>7</sup> 245 U.S. 418, at p. 426.

<sup>8</sup> The court's language is not to be read literally. Shares, not certificates, are split up or subdivided.

<sup>9</sup> That the analogy is not well taken will be clear from noting the difference in the two problems. The question in the trust cases is to find a basis for distributing the stock dividends as between life tenant and remainderman which would most nearly approach what the settlor of the trust had probably intended. A testator may indicate that stock dividends, apart from whether they are income or capital, be considered as part of corpus in order to safeguard the voting rights of the stock representing the corpus. A diversity of court rules exist on this subject. On the other hand, the question for income-tax purposes is whether a stock dividend is income within the meaning of the Sixteenth Amendment. See on this point, dissenting opinion of Mr. Justice Brandeis in *Eisner v. Macomber*, 252, U.S. 189, at pp. 234-36.

<sup>10</sup> Not until the 1917 Revenue Act was passed was there any specific provision in the law that dividends paid were deemed to be out of the most recent earnings or profits. See 1917 Act, sec. 1211 (31) (b) (40 Stat. 338); T.D. 3428, C.B. n-11; T.D. 3797, C.B. v-1, 158.

case was tried was silent with respect to stock dividends. Though *Towne v. Eisner* is an important link in the development of the Supreme Court's attitude on the stock-dividend question, it remained for *Eisner v. Macomber*, discussed below, to afford the court the occasion to re-examine the subject exhaustively.

#### THE 1916 ACT AND EISNER V. MACOMBER

Before *Towne v. Eisner* was decided by the Supreme Court, the Revenue Acts of 1916 and 1917 had become law. Both of these Acts expressly provided that stock dividends were taxable as income.<sup>11</sup> The revenue department continued to tax stock dividends under the specific provisions of the new Acts.<sup>12</sup> *Eisner v. Macomber*<sup>13</sup> soon gave

<sup>11</sup> Title 1, Part 1, sec. 2(a) of the 1916 law reads as follows (39 Stat. 756): "the term 'dividends' as used in this title shall be held to mean any distribution made . . . by a corporation . . . out of its earnings or profits accrued since March first, nineteen hundred and thirteen and payable to its shareholders, whether in cash or in stock of the corporation . . . which stock dividend shall be considered income, to the amount of its cash value."

Title XII, sec. 1211 of the 1917 law (40 Stat. 337-38) and Title II, Part 1, sec. 201 (a) and (c) of the 1918 law (40 Stat. 1059) read the same as the 1916 law except for the last clause which is as follows: "which stock dividend shall be considered income, to the amount of the earnings or profits so distributed."

<sup>12</sup> See Letters to Collectors, January 10, 1918, Corporation Trust Co., Income Tax Service, 1919, Par. 81.

<sup>13</sup> 252 U.S. 189, decided March 8, 1920. The facts reported are as follows: In January, 1916, the corporation (Standard Oil Company of California) issued new stock in the amount of 50% of that already outstanding and transferred from its surplus to capital stock an amount equivalent to the par value of the stock so issued. Mrs. Macomber, being the owner of 2,200 shares of the old stock received certificates for 1,100 additional shares, of which 18.07% or 198.77 shares par value \$19,877, was treated by the government as representing surplus earned since March 1, 1913, the date taken as approximating that of the adoption of the 16th Amendment, and hence as taxable income. She paid the tax on the \$19,877 under protest and sued to recover. The lower court decided in favor of the taxpayer, and the Government appealed to the Supreme Court.

The government's position is well stated in the following excerpt from its argument (p. 194):

"The important fact is that, assuming profits have been earned since March 1, 1913," the recipient of the stock dividend "has become richer since that date through the earnings of his invested capital. Congress has seen fit to say, that these earnings may accumulate free from tax until they are delivered to him either as cash or in stock. His gain comes, not from the declaration of a dividend of any kind, but from what his capital has earned. The only effect of the dividend is to fix the

the Supreme Court an opportunity to consider again the taxability of stock dividends as income. The court affirmed by a five-to-four vote the decision of the lower court in favor of the taxpayer, holding that stock dividends were not taxable as income under the 16th Amendment. The reasoning of Mr. Justice Pitney, representing the majority opinion, may be briefly analyzed.

(1) The decision of *Towne v. Eisner* is controlling in the instant case for the basis for the conclusion there reached<sup>14</sup> applies here. The essence of the reasoning there was that neither the corporation nor the stockholder is richer or poorer because of a stock dividend. The transaction is nothing but a readjustment of the evidence of title to what is already capital to the stockholder.

(2) A stock dividend is not income within the meaning of the 16th Amendment. Income, to be taxable must be realized. It is not enough to have an increment or gain in the invested capital; the gain, to be taxable, must be severed from the capital and be received or drawn by the recipient.<sup>15</sup> This

date upon which, under the law, his share of corporate earnings, previously accrued, becomes taxable."

Mrs. Macomber's counsel (Mr. Charles E. Hughes) argued as follows (pp. 195, 198): "Undivided corporate profits are not income to the stockholder. It is of the essence of income that it should be realized. . . . Income necessarily implies separation and realization. The increase of the forest is not income until it is cut. The increase of the value of lands due to the growth and prosperity of the community is not income until it is realized. . . . when a corporation earns profits, it receives money over the amount of its expenditures. The money belongs to the corporation; the profits are the property of the corporation. If the corporation distributes its earnings in dividends, properly so called, that is, in money or in property *in specie*, the stockholder has realized a gain and that gain is income. . . . The corporation must, of course, pay its income tax upon its profits, but there is no income to the shareholder unless he receives it. His share interest is a 'capital interest.'"

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"Income is the gain, come to fruition, from capital, from labor, or from both combined. This is sound doctrine both in law and in economics. Income of a corporation is not income of a shareholder until distributed. A 'stock dividend' is not income. It does not constitute a distribution of anything; it is a mere readjustment of capital."

<sup>14</sup> 245 U.S. 418.

<sup>15</sup> The following excerpts from Mr. Justice Pitney's opinion amplify this point:

Income is "not a growth or increment of value in the investment; but a gain . . . severed from the capital . . . and . . . received or drawn by the recipient [the

is a constitutional requirement, its essential thought being clearly set forth in the 16th Amendment.<sup>16</sup>

(3) Though a shareholder may sell his dividend stock, to do so decreases his capital interest and voting power. If he does not sell, unless he has other resources he cannot pay an income tax upon the dividend stock. This inability to pay the tax without converting a portion of the capital clearly shows that to tax a stock dividend is to tax a capital increase.<sup>17</sup>

(4) The dividend stock does not measure the gains accruing to the credit of the particular shareholder as a result of the profitable operation of the corporation. This is because (a) it would depend upon how long the shareholder had held his stock through-

taxpayer] for his separate use, benefit and disposal . . . " (p. 207).

Two attributes of income stand out in this definition: (1) there must be a gain, and (2) the gain must be realized.

The transaction involving a stock dividend "is merely bookkeeping that does not affect the aggregate assets of the corporation or its outstanding liabilities; it affects only the form, not the essence, of the 'liability' acknowledged by the corporation to its own shareholders, and this through a readjustment of accounts on one side of the balance sheet only; increasing 'capital stock' at the expense of 'surplus,' it does not alter the pre-existing proportionate interest of any stockholder or increase the intrinsic value of his holding or of the aggregate holdings of the other stockholders as they stood before. The new certificates simply increase the number of the shares, with consequent dilution of the value of each share.

"Far from being a realization of profits of the stockholder," a share dividend "tends rather to postpone such realization . . . The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance, and not to form, he has received nothing that answers the definition of income within the meaning of the 16th Amendment. . . .

"We are clear that not only does a stock dividend really take nothing from the corporation and add nothing to that of the shareholder, but that the antecedent accumulation of profit evidenced thereby, while indicating that the shareholder is the richer because of an increase of his capital, at the same time shows he has not realized or received any income in the transaction" (pp. 210-12).

<sup>16</sup> P. 207.

<sup>17</sup> P. 213.

out the operations that make the dividend possible, and (b) gain resulting from increase in value of invested capital is not income in any proper sense.<sup>18</sup>

(5) Congress has power to tax stock dividends, per se, but such a tax is in effect a property tax, which, being a direct tax, must under the Constitution as it now stands be levied among the several states according to population.<sup>19</sup>

Four justices dissented from the majority opinion. Their views are set forth in two opinions, each presenting different grounds for dissent.<sup>20</sup> The chief points made were

<sup>18</sup> Pp. 214-15.

<sup>19</sup> P. 217. This would be out of question as it is administratively impractical.

<sup>20</sup> Pp. 219-38.

The comments of Mr. Justice Holmes, concurred in by Mr. Justice Day, declared it unnecessary to demonstrate that a stock dividend is income in order to render it taxable under the 16th Amendment. The layman in voting for the Amendment, in Holmes' view, assumed that stock dividends would be subject to tax thereunder, and that such a tax would be an indirect tax whether stock dividends are income or not:

"I think that *Towne v. Eisner* . . . was right in its reasoning and result, and that on sound principles the stock dividend was not income. But it was clearly intimated in that case [Holmes delivered the opinion for the unanimous decision in that case] that the construction of the statute then before the court might be different from that of the constitution. . . . I think that the word 'incomes' in the 16th Amendment should be read in 'a sense most obvious to the common understanding at the time of its adoption. . . . For it was for public adoption that it was prepared. . . . The known purpose of this Amendment was to get rid of such questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest" (pp. 219-20).

Mr. Justice Brandeis' dissent, concurred in by Mr. Justice Clarke, attempts to meet the majority arguments more directly.

(1) Corporations retain profits, and yet make a distribution in two ways: through a share dividend or through a cash dividend accompanied by a preferential opportunity to subscribe for an increase of stock. Realistically viewed, argues Brandeis, the two methods are essentially identical, and since the latter is taxable as income to the shareholder, the former should be also (see pp. 220-24).

(2) In answer to Pitney's point that the corporation parts with nothing, Brandeis replies that assets do not have to be physically segregated before income to the recipient can be recognized, referring for support to the taxability of gains of a partner from partnership operations though such gains are still retained by the partnership (pp. 229-30).

(3) Turning to another line of attack, Brandeis argues that Congress has the right (a) "to make dividends representing profits, taxable as income, whether

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that (1) Congress has the power to expressly tax stock dividends, since the "known purpose" of the 16th Amendment was to permit this; (2) a stock dividend is substantially identical to a cash dividend with an option to buy more stock, and since the second is taxable income, why not the first?; (3) all dividends out of corporate earnings are basically the same and all should therefore produce taxable income, whether the medium of payment is cash or shares.

#### LATER ACTS AND DECISIONS

The decision in *Eisner v. Macomber* ended the attempts of Congress to tax stock dividends as income. Commencing with the 1921 Act, the Federal Revenue Laws have specifically exempted such dividends from income taxation.<sup>21</sup> Although the Macomber

the medium in which the dividend is paid be cash or stock"; and (b) "to define, as it has done, what dividends representing profits shall be deemed income" (pp. 237-38, 226-27).

For other criticism of the court's decision, see E. R. A. Seligman, Implications and Effects of the Stock Dividend Decision (1921), 21 Col. Law Rev. 313; E. H. Warren, Taxability of Stock Dividends as Income (1920), 33 Harvard Law Rev. 885.

Seligman's criticisms are mainly centered around the logical application of the reasoning in the majority opinion to questions which he raises concerning situations kindred to that involved in the principal case. His conclusion in most of the instances is that applying the court's principles would lead to undesirable results. "Many of these results are so fundamentally inconsistent both with our ordinary habits of thought and with considerations of practical expediency that we are led to ask whether it would not be preferable to abandon the premises even if thereby stock dividends should be rendered taxable" (p. 324).

<sup>21</sup> 1921 Act, Title II, sec. 201(d) (42 Stat. 228); 1924 Act, Title II, sec. 201(f) (43 Stat. 255); 1926 Act, Title II, Sec. 201(f) (44 Stat. 11); 1928 Act, Title I, sec. 115(f) (45 Stat. 822); 1932 Act, Title I, Sec. 115(f) (47 Stat. 204); 1934 Act, Title I, sec. 115(f) (48 Stat. 712); 1936 Act, Title I, sec. 115(f) (I) (74th Congress, 2nd Session, Public Law No. 740, p. 45). The cited provision in the Acts from 1921 to 1934 inclusive, stated, briefly: "A stock dividend shall not be subject to tax." The 1936 law has two paragraphs, the first of which corresponds to the earlier statement and reads as follows: "(1) General rule—a distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."

Two points may be noted as to the 1936 law: (1) As to stock dividends, there is recognition in the new law that some types of share dividends are constitutionally taxable. See discussion, *infra*, sections 4 and 5; and article 115-9 of the treasury regulations, which undertakes to

decision seemed to have laid to rest the question of taxability of stock dividends, it soon became apparent that the decision gave rise to new problems. A stock dividend is not subject to tax, but what constitutes a stock dividend?<sup>22</sup> Cases reaching the courts

apply the law to three specific examples taken for illustration (T.D. 4674 (August 6, 1936) xv I. R. B. No. 32, pp. 20-21); (2) as to stock rights, legislative recognition is given to common law holding of long standing, following decision in *Miles v. Safe Deposit & Trust Co. of Baltimore*, 259 U.S. 247 (1922), that rights to acquire stock are not subject to tax. Whether rights, like stock dividends, are, under certain circumstances, constitutionally taxable, is a question requiring an investigation of decisions that lie outside the scope of the present paper. A related problem also not dealt with here, is the determination of gain or loss upon the sale of rights. Reg. 65, Art. 39, 1924 Act, amended Reg. 62, Art. 39, 1922 Act, which was in force when the Miles case was decided, and attempted to conform with that decision. Reg. 69, Art. 39 (1), 1926 Act, in turn amended the 1924 regulation, and has been in force since January 1, 1925, the effective date of the 1926 Act, having been continued in Reg. 74, Art. 58, 1928 Act; Reg. 77, Art. 58, 1932 Act, and Reg. 86, Art. 22 (a)-8, 1934 Act. The present regulation does not conform to the method laid down in the Miles case but that case would be controlling if the difference in amount of tax justified the taxpayer's insistence upon that method.

<sup>22</sup> The difficulty was recognized by the Treasury Department as soon as the Macomber decision was made, as shown by the following excerpt from a ruling, outlining the application of the decision, issued on August 4, 1920 (T.D. 3052, C.B.3, p. 38):

"(1) Where a corporation being authorized so to do by the laws of the state in which it is incorporated, transfers a portion of its surplus to capital account, issues new stock representing the amount of the surplus so transferred, and distributes the stock so issued to its stockholders, such stock is not income to the stockholders, and the stockholders incur no liability for income tax by reason of its receipt.

"(2) Where a corporation, being thereunto lawfully authorized, increases its capital stock, and simultaneously declares a cash dividend equal in amount to the increase in its capital stock, and gives to its stockholders a real option either to keep the money for their own or to reinvest it in the new stocks, such dividend is a cash dividend and is income to the stockholders whether they reinvest it in the new shares or not.

"(3) Where a corporation, which is not permitted under the laws of the state in which it is incorporated to issue a stock dividend, increases its capital stock and at the same time declares a cash dividend under an agreement with the stockholders to reinvest the money so received in the new issue of capital stock, such dividend is subject to tax as income to the stockholder.

"(4) Where a corporation, having a surplus accumulated in part prior to March 1, 1913, and being thereunto lawfully authorized, transfers to its capital account a portion of its surplus, issues new stock representing the amount so transferred to the capital account and then declares a dividend payable in part in cash and in part in shares of the new issue of stock, that portion of the dividend paid in cash will to the amount of the

soon indicated that it was not always easy in practice to identify a stock dividend for purpose of income taxation.<sup>23</sup>

#### CASH V. STOCK DIVIDENDS

(1) Dividends declared payable in cash with an option to the shareholder to apply the dividend toward the purchase of more stock is a taxable gain to the recipient whether he takes cash or stock.<sup>24</sup> The reasoning is that the stockholder is not bound to the corporation to take the stock; the stockholder has received a cash dividend, which is income whether he reinvests it in new stock or not.<sup>25</sup> The 1936 Revenue Act carries this principle further by requiring that if the shareholder has an election as to the medium of payment desired, then any dividend distribution, whether in own stock or in cash or in non-cash property, is subject to tax.<sup>26</sup> (2) Dividends declared payable in

surplus accumulated since March 3, 1913 (sic) be deemed to have been paid out of such surplus, and be subject to tax, but the portion of the dividend paid in stock will not be subject to tax as income."

<sup>23</sup> As stated by the Board of Tax Appeals in a recent case: "Not every dividend in stock is a stock dividend, nor is every stock dividend a dividend in stock," *Tillotson Mfg. Co.* 27 B.T.A. 913 (1935). Colonel Montgomery in his *Federal Tax Handbook*, 1934, finds it necessary to remark that "Uncertainty regarding [the taxability of] stock dividends still exists" (p. 301).

<sup>24</sup> See T.D. 3052, *supra*, note 22, item (2).

<sup>25</sup> The Board of Tax Appeals in two cases dealing with optional dividends decided in favor of the government, but the reasoning of the court in both cases is different from that stated in the text to which this is the note. The ground for the decision in each case was that the option to take stock had in fact been exercised as to a reasonably large amount of the total dividend involved, thereby resulting in a material alteration in the proportionate interest held by the taxpayer in the corporation. See *Paper v. Com'r.*, 29 B.T.A. 523 (1933), where the taxpayer held both common and preferred stock and elected to take dividends on both classes in additional preferred stock; and *Wood v. Com'r.*, 29 B.T.A. 735 (1934), where the taxpayer held preferred stock and elected to take the dividend in additional preferred stock. See also, *infra*, note 34.

<sup>26</sup> The provision is as follows (sec. 115(f) (2)):

"Whenever a distribution by a corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or in rights to acquire its stock, of a class which if distributed without election would be exempt from tax under paragraph (1), or (B) in money or any other property (including its stock or in rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1)), then the distribution shall constitute a taxable

stock which the issuer offers to repurchase upon issue are held income subject to tax, the same as if they were made in cash.<sup>27</sup>

dividend in the hands of all shareholders, regardless of the medium in which paid."

Article 115-4 of the regulations covers this provision in the following words (see T.D. 4674 (August 6, 1936) xv I.R.B. No. 32, p. 21):

"If the shareholder has the right to an election or option with respect to whether a distribution shall be paid either (a) in money or in any other property or (b) in stock or rights to acquire stock of a class which, if distributed without an election, would not constitute income within the meaning of the Sixteenth Amendment of the Constitution, then the entire distribution is a taxable dividend regardless of

"(1) Whether the distribution is actually made, in whole or in part, in stock or in stock rights which, if distributed without election, would not constitute a taxable dividend;

"(2) Whether the election is exercised or exercisable before or after the declaration of the distribution; or

"(3) Whether the declaration of the dividend provides that payment will be made in one medium unless the shareholder specifically requests payment in the other."

Stock dividends issued in connection with optional dividend declarations have taken on a new importance in view of the likely impetus to their increased use under the 1936 Act. Because under the new law optional dividends are taxable in hands of the recipient, regardless of whether payment is in cash, stock or other medium desired, the dividend in its entirety becomes available as a "dividends-paid credit" or subtraction from the statutory amount of undistributed earnings on which the corporation must pay a surtax. Stock dividends issued as an election feature under optional dividend declarations may thus enable corporations to avoid both excessive cash dividends and heavy imposition of surtax. See, Act, sections 14 and 27; also articles 14 and 27 of the regulations (T.D. 4674 (August 6, 1936) xv I.R.B. No. 32, pp. 4-6 and 11-17). It is likely, however, that cases will soon reach the courts in which stockholders will question optional dividends that do not give a real option but in effect give stock dividends that under other circumstances would be tax-exempt upon receipt, in an effort to avoid taxation. A conflict of interest between a corporation and its stockholders seems unavoidable, especially where publicly owned corporations are involved, since taxability of a given "distribution" in recipient's hands is a prerequisite to the deductibility of the "distribution" from undistributed earnings subject to the new corporate surtax.

A real option would seem to exist where the corporation could in fact pay a reasonably large amount of the total dividend declared in any one of the media offered to stockholders. But even if this ability on the part of the corporation exists, it is possible that the courts will hold the optional dividend not taxable in recipient's hands (1) where the terms of the option were such as to practically compel stockholders to choose stock instead of cash, or (2) where all stockholders actually elect to take payment in stock which, if distributed without an election, would be tax-exempt within the meaning of the Sixteenth Amendment of the Constitution.

<sup>27</sup> See *Robinson v. Com'r.*, 69 F (2d) 972 (C.C.A. 5th, 1934), aff'g. 27 B.T.A. 1018 (1932). The provision under which the dividend was held taxable is section

Distinguishable from the foregoing are certain situations which have been held to produce tax-free stock dividends. (1) A dividend declared payable part in cash and part in stock is not taxable to the extent it is actually paid in stock.<sup>28</sup> (2) A dividend declared payable in cash but based on a prior agreement between stockholders, the corporation to apply the proceeds toward the purchase of additional stock, is a tax-free stock dividend.<sup>29</sup> The reasoning here is

115(g) of the Revenue Act of 1928 (45 Stat. 823) which reads as follows: "Redemption of stock—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend. . . ." This provision, as to stock dividends, has been in force since 1921 and is designed to prevent tax avoidance through payment of an ostensible stock dividend which is subsequently redeemed in cash or other property.

See also *Curllee v. Com'r.*, 28 B.T.A. 773 (1933); *Hill v. Com'r.*, 66 F (2d) 45, (1933) aff'g. 27 B.T.A. 44 (1932); cf. *Meyer v. Com'r.*, 27 B.T.A. 44 (1932), where the court held the redemption a *bona fide* exception under the given circumstances.

<sup>28</sup> See T.D. 3052, *supra*, note 22, item (4).

<sup>29</sup> *Irving v. United States*, 44 F (2d) 246 (Ct.Cl.1930): Stockholders agreed to endorse back their cash dividends checks for additional stock. A small amount of cash was actually paid because employees owning some 4% of the stock did not join in the agreement and hence cashed their checks, but this was held insufficient to change the character of the transaction.

*Jackson v. Com'r.*, 51 F (2d) 650 (C.C.A. 3rd, 1931): Two controlling stockholders of a closed family corporation entered into an oral agreement between themselves to pay back cash received as a dividend for additional shares of the corporation.

*United States v. Mellon*, 281 Fed. 645 (C.C.A. 3rd, 1922):

Corporation, in need of cash, decided to sell additional stock. The plan of financing as worked out under an agreement between the corporation and stockholders offered two shares at the par price of one to each stockholder. The agreement stipulated that, one of the shares was to be paid up through a 100% cash dividend, which was to be applied against the purchase. The purpose of the latter provision was to induce the stockholders to buy the other share. Some few stockholders did, however, receive cash.

In *United States v. Davison*, 1 F (2d) 465 (W.D.Pa. 1924), aff'd 9 F (2d) 1022 (C.C.A. 3rd, 1926) cert. denied, 271 U.S. 670 (1926), holding and facts were same as the Mellon case in preceding paragraph, both cases arising out of the same transaction.

See also *Norrell v. Com'r.*, 6 B.T.A. 56 (1927); *Weiss v. Com'r.*, 7 B.T.A. 467 (1927); Appeal of *Zellerbach*, 2 B.T.A. 1076 (1925); *Wright v. Com'r.*, 10 B.T.A. 806 (1928); *Smith v. Com'r.*, 21 B.T.A. 782 (1930).

that the effect of the agreement is to bind the shareholders to use their dividends in no other way but in subscribing for new stock. Evidence pointing to financial inability to pay a cash dividend is considered a material factor along with agreement entered into beforehand to establish intent to make a stock dividend. (3) A dividend declared payable in cash but actually applied to reduce claim against stockholders on account of unpaid stock subscriptions is an exempt stock dividend.<sup>30</sup> This does not point, however, to a change in the general principle that a taxpayer may receive income from the cancellation of an indebtedness to the corporation,<sup>31</sup> as the recorded cases turn strictly on the facts presented.<sup>32</sup>

An agreement per se, however, cannot be set up to establish a tax-free stock dividend; the stockholders must be legally bound to take the stock when the cash dividend is declared. See Appeal of *Paul*, 2 B.T.A. 150 (1925), where the agreement was held inoperative because it took place some seven days after date cash dividend was declared; Appeal of *Hunt*, 5 B.T.A. 356 (1926), where the agreement was held inoperative because it was among the stockholders themselves, the directors participating being considered as not having represented the corporation.

<sup>30</sup> *Teehan v. United States*, 125 F (2d) 884 (D. Mass. 1928), where the court pointed out that stockholders received nothing tangible; *Michaels v. McLaughlin*, 20 F (2d) 959 (N.D. Calif. 1927), where the court stressed the fact that the California statute made the obligation of the subscriber contingent upon a formal call by the corporation, which call was made more improbable due to presence of large surplus; *Carlston v. Com'r.*, 22 B.T.A. 217 (1931), where no payment on account of subscription had been made for six years when the amount unpaid was reduced through surplus charges, though the date of original subscription goes back many years earlier.

<sup>31</sup> See *Fitch v. Com'r.*, 70 F (2d) 583 (C.C.A. 8th, 1934) aff'g. 27 B.T.A. 615 (1933); and *Miller v. Com'r.*, 25 B.T.A. 418 (1932) (Appeal to C.C.A. 2d dismissed Aug. 15, 1933).

<sup>32</sup> In the *Teehan* case, the cash dividend was declared on condition that 90% of the stockholders apply the proceeds to pay up on the stock. In the *McLaughlin* case, the indebtedness was contingent and not likely to materialize. In the *Carlston* case, the indebtedness had stood on the books for many years, was subject to a formal call by the corporation, and no payment on account of subscriptions had been made for six years.

But cf. *Brading v. Com'r.*, 17 B.T.A. 436 (1929), where subscribers gave their promissory notes, attaching thereto an assignment of dividends as declared until notes are paid off. Held: that dividends as declared are cash dividends and therefore taxable. Reason: The corporation was not bound to apply the dividend declared to unpaid subscriptions; moreover, the resolution declaring the dividend made no mention about the mandatory application of proceeds to pay up stock

The problem of distinguishing between cash and stock dividends will continue to give the courts difficulty so long as it is their avowed policy to lay aside *form* and look to *substance* in determining whether a particular dividend transaction represents a *real* stock dividend. The principles stated in the foregoing paragraphs do, however, indicate the specific guides which the courts are using in deciding whether a particular dividend is in cash or in stock.

#### DIVIDENDS TO COMMON STOCKHOLDERS

Another question is whether an exempt stock dividend occurs where a dividend is made (1) in preferred stock to holders of a different class of stock, or (2) in preferred stock to holders of the same class of stock, or (3) in common stock to holders of a different class of stock. The indicated phases of this question were not dealt with in *Eisner v. Macomber* since that case involved a dividend in common stock to a holder of the same class of stock. In judging cases reaching them, the courts have, however, relied on principles stated in the *Macomber* case, chiefly those concerning realization of gain, separation from corporate capital, and maintenance of stockholder's proportionate interest.

As early as 1921, the Treasury Department issued a ruling making dividends in preferred stock tax exempt stock dividends.<sup>33</sup> So far as the preferred stock is issued to common stockholders and there is no preferred stock outstanding prior to such issue, the foregoing rule appears sound, and the courts have so held.<sup>34</sup> The reasoning here is that each stockholder receives a *pro rata*

subscriptions. These facts seem to distinguish this case from *Teehan v. United States*, *supra*.

<sup>33</sup> O.D. 801, 4 C.B. 24 (1921):

"A stock dividend paid in true preferred stock is exempt from tax the same as though the dividend were paid in common stock; however, if the stock issued and distributed as a dividend ranks with or prior to the interest of general creditors (with respect to the payment of either interest or principal), it cannot be considered true preferred stock, and must be treated as income to the recipient."

<sup>34</sup> See *Laun v. Com'r.*, 26 B.T.A. 764 (1932); *Brown v. Com'r.*, 26 B.T.A. 901 (1932), *aff'd* 69 F (2d) 802 (1934) (cert. denied, 293 U.S. 570 (1934)); *Clark v. Com'r.*, 25 B.T.A. 1225 (1933), *aff'd* 77 F (2d) 89. (1935); *cf.* note 42 *infra*.

share of the new preferred and there is no change in the stockholder's proportionate interest in the net worth of the corporation. If, however, there is preferred stock already outstanding the position of the common stockholders may be changed for the better if earnings are insufficient to pay dividends on the original preferred or, in case of dissolution, if assets are insufficient to pay the original preferred stockholders. Alteration of the stockholders' position is now effected in two directions, in earnings upon declaration of dividends and in assets at dissolution. The board of tax appeals has held that this is sufficient ground to bring stock dividends issued under such circumstances within the test of alteration of pre-existing proportionate interest, which is one of the tests of a taxable stock dividend according to *Eisner v. Macomber*,<sup>35</sup> that this type of dividend produces, for the recipient, a proportional interest in the corporation that is "essentially different" from his former interest,<sup>36</sup> and hence constitutes income to him.

<sup>35</sup> See *Torrens v. Com'r.*, 31 B.T.A. 787 (1933); *Gowran v. Com'r.*, 32 B.T.A. 820 (1935). The court's argument in the latter case reads, in part, as follows (at page 824):

"our . . . inquiry is the taxable status of this new preferred stock, not from the standpoint of the corporation but from that of the common stockholders . . . the petitioners . . . as common stockholders, by the receipt of the . . . preferred stock, as a dividend, received rights in the assets of the corporation, as to future dividends, and upon liquidation, which were . . . [previously] limited to the then outstanding preferred stock."

Member McMahon dissented, holding that the treasury regulations should be strictly followed:

(1) The Act states that a "stock dividend shall not be subject to tax" (see, *supra*, note 21).

(2) Commencing with T.D. 3059, issued in 1920, and subsequent regulations down to the present, the treasury department has "repeatedly ruled that a stock dividend 'in whole or in part of a character and preference materially different from the stock upon which the stock dividend is paid' is not taxable to the stockholder receiving the same" (*Gowran v. Com'r.*, 32 B.T.A. 827 (1935)). Legislative approval of this administrative interpretation is evident, McMahon continues, from the "substantial reenactment in later acts of provision, theretofore construed by administrative officers . . ." (*loc. cit.*).

McMahon also attempted to meet the majority argument more directly by denying that the recipients of the preferred stock received any additional rights and preferences that they did not have before the dividend (see e.g. pages 830-32 of the decision).

<sup>36</sup> This principle was developed and applied by the Supreme Court in a series of reorganization cases from

A variation of the above problem is a dividend in preferred stock to holders of the same class. Under the general treasury ruling

1921 to 1925, as follows: *United States v. Phellis*, 257 U.S. 150 (1921); *Rockefeller v. United States*, 257 U.S. 176 (1921); *Cullinan v. Walker*, 262 U.S. 134 (1923); *Weiss v. Stearn*, 265 U.S. 242 (1924); and *Marr v. United States*, 268 U.S. 536 (1925).

In the *Phellis* case, A company transferred its assets to B company, newly organized for the purpose under the laws of a different state and received in return the stock of the latter company. A portion of this stock was then distributed as a dividend by the A company to its stockholders, with a charge against earnings, the A company continuing as a holding company. The other cases were similar in their facts, with the following points of difference. In the *Rockefeller* case, only a portion of the assets, representing a division of operation, were transferred to a new company, which was organized under the laws of the same state. In the *Cullinan* case, the assets were transferred to two new companies, organized under the laws of the same state which issued stock and bonds in return, these bonds and stock being turned over to a third new company, organized under the laws of a different state, which became a holding company. The stock of the third new company and the bonds of the first two new companies were then used to take up the stock of the original company, which dissolved. In this case, a dividend in liquidation was involved, the government insisting that a stockholder of the original company was subject to income tax for the excess of the value of the dividend over the cost of the stock in the dissolved company. In the *Marr* case, both preferred and common stock were involved, the new company was organized under the laws of a separate state, and, like the preceding case, the original company dissolved. The *Phellis* and *Rockefeller* cases were decided in 1921 under the 1913 Revenue Act; the *Cullinan* case in 1923 under the 1916 Act; and the *Marr* case in 1924 under the 1916 Act.

In all of the four cases noted, the court held the dividend in question subject to income tax. The taxpayer's contention as to non-taxability in all four cases turned on (1) the essential identity of old and new companies, the assets and personnel being substantially the same after the reorganization as before, and (2) on the bona fide character of the transaction, making the dividend in effect an exempt stock dividend. The government's contention, upheld by the court, turned on evidence as to separate corporate entities, the receipt of the new securities giving the stockholder a new and different interest for his old one. The following statement of these opposing contentions, set forth in the *Marr* case, is representative of the other three cases:

"Marr contends that since the new corporation was organized to take over the assets and continue the business of the old, and his capital remained invested in the same business enterprise, the additional securities distributed were in legal effect a stock dividend.

"The government insists that identity of the business enterprise is not conclusive; that gain in value resulting from profits is taxable as income, not only when it is represented by an interest in a different business enterprise or property, but also when it is represented by an essentially different interest in the same business enterprise or property; that in the case at bar, the gain actually made is represented by securities with essentially different characteristics in an essentially different

mentioned,<sup>37</sup> this type of dividend is also exempt from taxation. No case was found in which the point was at issue, but if a case

corporation; and that, consequently, the additional value of the new securities, altho they are still held by the Marrs, is income. . . . In our opinion the government is right" (p. 541).

In *Weiss v. Stearn*, decided in 1924 under the 1916 Act, the new company was organized under the laws of the same state. The old company was dissolved, the stockholder in that company receiving cash and securities in new company. The court held that considering the transaction as a whole it amounted to a financial reorganization and that the stockholder was subject to income tax on the cash received, but not on the stock, the latter being regarded as in effect a dividend in the stock of the old company. This holding was reconciled with that applied in the other cases noted above on the ground that the facts are distinguishable. "Technically there was a new entity; but the corporate identity . . . was substantially maintained because the new corporation was organized under the laws of the same state, with presumably the same powers as the old. There was also no change in the character of the securities issued. . . . [Hence] the proportional interest of the stockholder after . . . was . . . exactly the same as if . . . five shares of reduced par value stock had been issued in place of every two shares of the old stock . . . the transaction was . . . in essence, an exchange of certificates representing the same interest, not an exchange of interests" (pp. 541-42).

Beginning with the 1921 law, Congress made transactions of the type illustrated in the foregoing cases expressly exempt from income taxation. The 1921 provision (Section 202(c) (2), (42 Stat. 230)) states that no gain or loss shall be recognized, "when in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him stock or securities in a corporation a party to or resulting from such reorganization. . . ." Similar in language is the corresponding provision in subsequent acts. See, e.g. sec. 112(b) (3) of latest (1936) Act: "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."

No cases of the type discussed above have reached the Supreme Court under the 1921 and later Acts, but numerous cases have appeared before the board of tax appeals and the lower federal courts. The government has relied on *Marr v. United States*, while the taxpayer has used *Weiss v. Stearn* for authority. The decision is generally for the government, as the exemptions in connection with reorganization have been strictly construed. See *Noll v. United States*, 61 Ct. Cl. 180 (1925) cert. denied 270 U.S. 649 (1926); *Wright v. Com'r.*, 50 F (2d) 727 (C.C.A. 4th, 1931), cert. denied, 284 U.S. 652 (1931); *United States v. Siegel*, 52 F (2d) 63 (C.C.A. 8th, 1931), cert. denied, 284 U.S. 670 (1931); *Burnet v. Kountz*, 66 F (2d) 141 (C.C.A. 8th, 1933), aff'g. 24 B.T.A. 405 (1931); *Bancker v. Com'r.*, 76 F (2d) 1 (C.C.A. 3th, 1935).

For a detailed treatment of tax-free exchanges of securities in reorganizations, see Paul and Mertens, 2 Law of Federal Income Taxation (1934), discussion beginning with sec. 18.104.

<sup>37</sup> See, *supra*, note 33.

does reach the courts, such a dividend is likely to be held taxable. The grounds for this are the same as those pointed out in the preceding case, the additional rights in the present instance being comparatively more certain to be realized.

Dividends in common stock to holders of a different class constitute a third type. This type was classed as an exempt stock dividend under treasury regulations prior to the enactment of the 1936 Act.<sup>38</sup> In this respect the regulation has been consistent with those covering the two types already discussed. The courts, however, have denied exemption from taxation of dividends in common stock received by holders of a different class of stock, one of the cases (*Koshland vs. Helvering*) having recently reached the Supreme Court.<sup>39</sup> It is held that the ef-

fect of this type of dividend is also to convey to the recipient new and separate rights: rights in dividends, rights in assets at disso-

be distributed between the two classes of stock in the ratio that the market value of each class bore to the combined total market value of both at time of sale (see Art. 1599, Reg. 69, Act of 1926, which controlled in the *Tillotson Case*. For later regulations bearing similar provision see, *supra*, note 38. On the other hand, if the dividend stock is considered income, the original cost should not be so allocated. The determination of the amount of taxable gain on the sale of the preferred stock thus involved the prior question as to whether the dividend stock was income or not.

In the *Tillotson case*, the circuit court stated on pages 190-91, after citing *Eisner v. Macomber*:

"Two tests were thus established for distinguishing a taxable from a non-taxable dividend in stock:

"(1) Severance of assets from the corporation, and  
"(2) alteration of the pre-existing proportionate interest of the stockholders.

"In the instant case, the first test was met . . .

"The second test was not met . . .

"... the right to share in assets upon dissolution, and in . . . dividends, was materially altered. . . . Each preferred stockholder . . . secured new voting rights, and additional property rights . . .

"... the Commissioner erred in applying to the transaction one test only of those laid down in *Eisner v. Macomber*" and the other decisions cited by the judge in the instant case.

The board of tax appeals had earlier arrived at the same conclusion, based on the same reason, but not without dissent from Member Black, who said (27 B.T.A. 920 (1933)):

"The error . . . of the majority opinion . . . is that it assumes that the only kind of stock dividend exempted from taxation by sec. 201 (f) is such a stock dividend as was present in *Eisner v. Macomber* . . . (page 922 of decision).

"... the essential fact is not . . . "the maintenance of "the same proportional interest . . . but . . . severance" of assets from the corporation and "payment to the stockholder" for his separate use and benefit (page 923 of decision).

In other words, Member Black preferred test 1 over test 2 (see majority opinion of circuit court above). In addition, he made reference to the treasury regulations long in force treating stock dividends as non-taxable (see pages 919-20 of decision).

The more recent case of *Koshland v. Helvering*, *Com'r.*, reached the Supreme Court, where Mr. Justice Roberts delivered the opinion of the majority, Justices Stone and Cardozo dissenting. Excerpts from the majority opinion are given below:

"Soon after the 1921 Act was passed, this court pointed out [in a series of reorganization cases discussed in note 36, *supra*] the distinction between a stock dividend which worked no change . . . the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and such a dividend where there had either been changes of corporate entity or a change in the nature of the shares issued as dividends whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest.

<sup>38</sup> See T.D. 3059, issued August 16, 1920, amending article 1547 of Reg. No. 45 (1916 Act), where it is stated that in computing taxable income on the occasion of a sale of dividend stock, if the dividend stock is of a character or preference materially different from the stock upon which the stock dividend is paid the cost of the old stock shall be apportioned between the old and the dividend stock. The assumption here is of course that the dividend stock is an exempt stock dividend, though of a class different from the old stock. (But note, too, that applying the stock dividend against the base of the old stock amounts to adding it to the selling price, thereby increasing the tax paid.) T.D. 3059, containing the provision stated was incorporated in article 1548 of Reg. 62 (1921 Act), and subsequent regulations carried forward a similar provision (see Art. 1547 and 1548, Reg. 65, 1924 Act; Art. 1547 and 1548, Reg. 69, 1926 Act; Art. 627 and 628, Reg. 74, 1928 Act; Art. 627 and 628, Reg. 77, 1932 Act; Art. 115-17 and 115-18, Reg. 96, 1932 Act).

<sup>39</sup> The recorded cases are two, both having arisen within the last two years. See *Tillotson Mfg. Co. v. Com'r.*, 27 B.T.A. 913 (1933), aff'd in 76 F (2d) 189 (C.C.A. 6th, 1935); and *Com'r. v. Koshland*, 30 B.T.A. 1460 (1934), rev'd in 81 F (2d) 641 (C.C.A. 9th, 1936), rev'd in 56 U.S. 767 (1936), C.C.H., Fed. Tax Service (1936), vol. 4, Par. 9294, decided on May 18, 1936.

Montgomery, *Federal Tax Handbook* (1934), p. 302, considers the *Tillotson* decision unsound, but offers no reason for his position.

Both cases involved preferred stockholders who received dividends in common stock. The dividend stock was not reported as income when received, but subsequently upon the occasion of the sale of the preferred stock the question arose whether in the determination of the amount of taxable gain resulting from the sale of the preferred stock the dividend stock should be treated as income or merely as additional evidence of the taxpayer's capital investment. If the dividend stock is treated as re-arrangement of the same capital investment, the taxpayer in effect sold a portion of that investment and the original cost of the holding should

lution, and right to vote. The result is that the recipient acquires an interest materially different from that which his former stockholding represented. Dividend shares conferring such new rights therefore constitute income for purposes of taxation in the light of the judicial history.<sup>40</sup>

"Nevertheless the successive statutes and treasury regulations . . . remained unaltered . . . [but] the question here . . . is not merely of our adopting the administrative construction but whether it should be adopted if in effect it converts an income tax into a capital levy.

"We are dealing solely with an income tax Act. Under our decisions the payment of a dividend of new common shares, conferring no different rights or interests than did the old . . . does not constitute the receipt of income by the stockholder. On the other hand, where a stock dividend gives the stockholder, an interest different from that which his former stockholdings represented he receives income. The latter type of dividend is taxable as income under the Sixteenth Amendment . . .

"Congress having clearly and specifically declared [in the relevant capital gains provisions of the Revenue Acts, the 1928 Act, controlling here . . . See Section 113(a) (45 Stat. 815) and Section 113 (45 Stat. 818)] that in taxing income arising from capital gain the cost of the asset disposed of shall be the measure of the income, the Secretary of the Treasury is without power by regulatory amendment to add a provision that income derived from the capital asset shall be used to reduce cost."

The argument in the dissenting opinion was chiefly confined to the point that the broad statement in the Revenue Act, that "Stock dividends shall not be subject to tax" as income at the time of distribution "has had a practical construction through administrative action and legislative acquiescence. . . ." The opinion concluded that "Following the analogy of *Miles v. Safe Deposit and Trust Co. of Baltimore*, 259 U.S. 247, 263 (1922), the cost of all the shares is properly distributed between the investment and its accretions, between the old shares and the new. . . ."

<sup>40</sup> The position of the courts is concededly based also on a strict construction of the provision in the Revenue Acts prior to 1936 which stated that: "A stock dividend shall not be subject to tax" (see *supra*, note 21), in contrast to the broad view undertaken by the treasury regulations, which have interpreted the provision to exempt all income in the form of dividend stock.

As to the more basic question of the philosophical distinction between stock dividends of the types discussed in this section and the type involved in *Eisner v. Macomber*, the limits of the present chapter do not permit inquiry. For discussions of the general problem, see, e.g., the cases cited in note 36, *supra*; 2 Paul and Mertens, *Law of Federal Income Taxation* (1934), sec. 18.26; Rottschaefer, H., *Concept of Income in Federal Taxation* (1929), 13 Minn. Law Rev. 637; Hewett, W. W., *The Definition of Income and its Application in Federal Taxation* (1925); Magill, R., *Taxable Income* (1936); Seligman, E. R. A., *Are Stock Dividends Income?* in his *Studies in Public Finance* (1925), chapter 5; and *The Federal Income Tax*, Columbia University Lectures (1921), edited by R. M. Haig.

This section, like the one preceding it, shows clearly that the courts have tended over the years to restrict the decision in *Eisner v. Macomber* to the "simple stock dividend" there involved.<sup>41</sup> The method of analysis employed has generally been to look through form to substance, with the primary concern over the effect of the dividend on the recipient and whether the dividend may be *constitutionally* taxable as income. As to the constitutional question, the courts have continued to rely upon the two tests of income realization laid down in the *Macomber* case, namely (1) severance of assets from the corporation and receipt thereof by the taxpayer for his separate use and (2) alteration of pre-existing proportionate interest in corporate net worth.<sup>42</sup> However, the courts have held the second sufficient without the first to satisfy the requirement of realization.<sup>43</sup> Early evidence of this trend was found in a series of reorganization cases decided between 1921 and 1925, discussed above.<sup>44</sup>

#### EFFECT OF STATE INCOME-TAX LAWS

State income taxation is now in effect in

<sup>41</sup> This trend was finally given statutory recognition in the 1936 law. Compare the provision in the Acts which from 1921 to 1934 covered the exemption of stock dividends from taxation with that in the 1936 law. See *supra*, note 21.

<sup>42</sup> A third test of income realization in connection with stock dividends, insofar as such a test is distinguishable from the two stated in the text, may be adopted by the courts in view of the reasoning in *Koshland v. Helvering*. In the decision of that case, the Supreme Court laid considerable stress on the issuance of a different class of stock, per se, declaring: "Where a stock dividend gives the stockholder an interest different from that which his former stockholdings represented, he receives income." Accordingly, the following types of stock dividends may in the future be held by the courts to afford a sufficiently "different interest" to be deemed taxable upon receipt: (1) Dividends on common stock paid in stock of a different class, where no other class than common is outstanding at date of declaration; (2) Dividends on common stock paid in stock of a different class, where the latter is junior to preferred stock that is outstanding at date of declaration.

<sup>43</sup> Two interpretations of this holding are possible. One is that the second test is the more important, since it emphasizes the effect on the recipient of the dividend, which is what really matters for income taxation. The other is that both tests are equally valid, but that each views the problem from different angles, so that either test may be used.

<sup>44</sup> See, *supra*, note 36.

thirty-five states.<sup>45</sup> The state laws generally follow the federal act. Differences between the state laws and the federal act exist, however, on a number of important points. These differences are concerned chiefly with the jurisdictional limitation imposed by the federal constitution on the right of a state to tax out-of-state income.<sup>46</sup> Differences also exist between the state laws themselves, due to peculiarities of respective constitutions and different legislative policies. It is the purpose here to consider briefly the taxability of stock dividends under these laws. The discussion is confined to analysis of statutes, as, save for a few decisions considered in the section following, no case authority on the subject appears to exist.

<sup>45</sup> For a historical account of the movement of state income taxation, see (1) Annual Proceedings of the American Tax Association; and (2) "State Income Taxes" (1930), a two-volume study by the National Industrial Conference Board. A brief history of this movement is sketched below.

The modern movement of state income taxation began in 1911, when Wisconsin passed an income-tax law. Prior to 1911, several states had tried income taxation in one form or another, and for varying periods of time: Massachusetts, Virginia, North and South Carolina, New Hampshire, Oklahoma and Delaware. The Virginia income-tax law in force today dates back to 1843, though minor changes have been made over the years. From 1911 to 1919 eight states followed Wisconsin's example: Connecticut (1915), Oklahoma (1915), Delaware (1917), Massachusetts (1917), Missouri (1917), Montana (1917), New York (1917), and North Dakota (1919). In the next decade (1919 to 1928), the movement slackened its pace: Tennessee passed a law in 1923; New Hampshire enacted a partial one (on income from intangibles) in 1923; and the laws of three states were modernized (North Carolina (1921), South Carolina (1922) and Mississippi (1924)). Mississippi passed its first law in 1912, but this was modelled after the Oklahoma Act of 1907 and the South Carolina Act of 1902. Since 1929, the movement has resumed its rapid spread among the states. In the four years, 1929-1932, seven states were added to the list, bringing the total to twenty-two (including Virginia): Arkansas (1930), California (1929), Georgia (1929), Oregon (1929), Utah (1931), Idaho (1931), and Vermont (1931). The last four years, 1932-1936, saw the greatest growth, when thirteen more states enacted income-tax laws: Alabama (1933), Arizona (1933), Indiana (1933), Iowa (1933), Kansas (1933), Kentucky (1936), Louisiana (1934), Maryland (1935), Minnesota (1933), New Mexico (1933), Pennsylvania (1935), South Dakota (1933), and West Virginia (1935).

<sup>46</sup> For a recent discussion of this subject see Traynor, R. J., Keesling, F. M., The Scope and Nature of the California Income Tax (1936) 24 Calif. Law Rev., 493; and Nossaman, W. L., State Taxation of Income (1936), 24 Calif. Law Rev., 524.

#### EARLY DECISIONS IN MASSACHUSETTS, WISCONSIN AND NEW YORK

Massachusetts' first income tax law, enacted in 1916, did not specifically either include or exempt stock dividends as taxable income.<sup>47</sup> In the same year, *Trefry v. Putnam* gave the Massachusetts court its opportunity to interpret the law. The court decided that stock dividends were subject to income tax, basing its position on arguments similar to those later used by Mr. Justice Brandeis in the Macomber case.<sup>48</sup> Under authority of the Putnam case, stock dividends were taxed until 1920, when the personal income tax law was changed to expressly exempt such dividends from income taxation.<sup>49</sup>

Wisconsin enacted its first income tax law in 1911. This law remained silent as to taxability of stock dividends.<sup>50</sup> In 1917, how-

<sup>47</sup> Mass. Gen. Acts of 1916, ch. 269, sec. 2. "Income of the following classes . . . shall be taxed . . . (b) Dividends on shares in . . . corporations."

<sup>48</sup> See note 20 *supra*.

Mr. Chief Justice Rugg of the Massachusetts Court expressed the majority position in the following words:

"In essence the thing which has been done is to distribute a symbol representing an accumulation of profits, which instead of being paid out in cash is invested in the business, thus augmenting its durable assets. In this respect of the case the substance of the transaction is no different from what it would be if a cash dividend had been declared with the privilege of subscription to an equivalent amount of new shares. . . . From the viewpoint of the stockholder, he has received in the form of dividend in stock a thing with which theretofore he could have no tangible dealings." (227 Mass. 522, at 535, 536, 16 N.E. 904, at 911.)

The Putnam case was followed in *Tilton v. Trefry*, 238 Mass. 596, 131 N.E. 219 (1921), and in *Lanning v. Trefry*, 247 Mass. 496, 142 N.E. 829 (1924) where Mr. Chief Justice Rugg said: "Even in the Macomber case four out of nine justices believed that a stock dividend could be taxed as income . . . the decision of the Putnam case was rendered first. . . . It is adopted [here] without more discussion. . . ."

<sup>49</sup> Mass. Gen. Acts of 1920, ch. 352, Sec. 1:

"Income of the classes described . . . shall be taxed at the rate of six percentum per annum . . . (b) dividends, other than stock dividends paid in new stock of the company issuing the same, . . ."

The law taxing corporate income, however, is not explicit on the point.

<sup>50</sup> Wisconsin Session Laws of 1911, ch. 658, Sec. 1: "The term 'income' . . . shall include . . . (d) all dividends . . . derived from stock. . . ."

No case was found dealing with taxability of stock dividends under the 1911 law.

ever, the law was amended to specifically make such dividends subject to tax.<sup>51</sup> The constitutionality of this provision was challenged in *Dulaney v. Nygaard*, decided in 1921.<sup>52</sup> The Wisconsin Court faced the task of determining if the existing law on the point was within the legislature's constitutional authority to tax "income."<sup>53</sup> The court decided that it was.<sup>54</sup> Under authority

<sup>51</sup> Wisconsin Session Laws of 1917, ch. 247, Sec. 1: "The term 'income' . . . shall include . . . (b) all dividends derived from stocks . . . 'dividends' . . . shall be held to mean any distribution made by a corporation, . . . out of its earnings or profits accrued since January 1, 1911 . . . and paid . . . in cash or in stock of the corporation. . . ."

<sup>52</sup> *State Ex Rel Dulaney v. Nygaard*, 174 Wis. 507, 183 N.W. 884 (1921). Followed in *State Ex Rel Van Dyke v. Cary*, 181 Wis. 504, 191 N.W. 546 (1923).

<sup>53</sup> Article VIII, sec. 1 of the state constitution, as amended in 1908, declared that " . . . Taxes may also be imposed on incomes . . . " (see page 599 of decision in *Nygaard* case, note 52, *supra*).

<sup>54</sup> The excerpts given below indicate the reasoning used by the court in the *Nygaard* case.

"As between life tenant and remainderman the word (income) has a settled meaning in this state . . . we . . . see no reason for . . . a different meaning as between a taxpayer and the state . . . [page 604]."

" . . . It is a matter of common knowledge that stock dividends were welcomed by shareholders in about the same manner as cash dividends; that when it was known . . . that stock dividends were to be issued the market value of the stock advanced. Stockholders and the public realized that when such dividends were issued, the owner of the stock acquired new and substantial rights. Although his proportionate interest in the . . . corporation was not increased, he retained his original shares and received others which represented surplus earnings . . . added . . . to capital. Although . . . the new certificates . . . [did not increase] his proportionate interest . . . he was assured that the corporation had made . . . earnings not likely to be . . . diverted from the business. . . ."

In reply to the argument that income is not realized through the receipt of dividend stock, the court said "we consider this objection rather theoretical than practical. Stock dividends actually earned and legally declared have a market value and are easy to transfer. The owner . . . [may] keep . . . or . . . sell his stock, but . . . the right of the legislature to impose a tax upon his profits . . . [is not] determined by the exercise or non-exercise of such option. . . ."

" . . . The dividend . . . [stock] affords an evidence of the stockholder's share in the earnings . . . of the company. It was evidently the view of the legislature that the time of receiving such dividends was the most convenient occasion for levying the tax upon the stockholder's interest in the undivided gains . . . and that the stockholder could properly be taxed upon this increment to his wealth evidenced by cash or stock dividend. . . ."

"We cannot believe that the legislature and the people adopting the amendment gave the word . . . [income] any . . . technical and restricted meaning . . .

of this case, the enforcement of the statute continued. Stock dividends were thus made taxable with the 1917 amendment of the law. Taxation continued until 1927, when the law was changed to exclude stock dividends from taxable dividends.<sup>55</sup>

New York's original income-tax law of 1919 subjected stock dividends to income taxation.<sup>56</sup> In March, 1920, the attorney-general filed with the state comptroller an opinion to the effect that under the statute a stock dividend is not a "gain, profit or income"<sup>57</sup> and hence is not taxable as such.<sup>58</sup> The comptroller's office accepted this ruling and adhered to it thereafter in enforcing the law.<sup>59</sup> In 1925, the government taxed stock dividends received by a beneficiary of a trust on the ground that there was a distinction between a recipient who had legal title to the stock on which the dividend was paid and one who came into possession of the dividend by virtue of a direction from a trust. In *People v. Gilchrist*<sup>60</sup> the lower New York court decided against the taxpayer, but for reasons different from those of the tax commission. The court based its decision upon the fact that stock dividends were specifically taxable under the state law. The regulations issued under the law by the comptroller's office were deemed by the

It was undoubtedly their intention . . . to shift . . . the load of taxation upon those best able to pay . . . [and to prevent] the gains of stockholders . . . [from increasing] indefinitely . . . [thereby making] the liability of those gains to taxation . . . depend upon the manner in which . . . directors . . . declare dividends" (pp. 605-9).

<sup>55</sup> Wisconsin Session Laws of 1927, Ch. 539, Sec. 2 (2) (b) (5): "A dividend paid by a corporation in its own capital stock shall not be subject to income tax as a dividend at the time of its receipt by a stockholder; . . ."

<sup>56</sup> Laws of New York, 1919, Ch. 627, Sec. 359 (1): "'Gross income' . . . includes gains, profits and income . . . derived from . . . dividends . . ." Sec. 350 (8): Dividends mean "any distribution made by a corporation out of its earnings or profits . . . whether in cash . . . property or . . . stock of the corporation."

<sup>57</sup> See *supra*, note 56.

<sup>58</sup> See historical statement by Mr. Chief Justice Cardozo in *People Ex Rel Clark v. Gilchrist*, 243 N.Y. 173, 153 N.E. 39 (1926).

<sup>59</sup> Article 61 of the regulations under the Personal Income Tax Act, issued in November, 1921, reads as follows: "A true stock dividend is not taxable as a dividend."

<sup>60</sup> *People Ex Rel Clark v. Gilchrist*, App. Div. 3rd Dept., 211 N.Y.S. 679 (1925).

court an exercise of unauthorized power. The case was appealed, and by the time the Supreme Court of the state was ready to consider it, the statute had been amended to exclude stock dividends from taxation.<sup>61</sup> The ruling of the lower court was reversed on the ground that the tax commission's distinction between recipients of stock dividends was unwarranted.<sup>62</sup>

#### PRESENT STATUS UNDER STATE ACTS

Twenty-eight states have income tax laws which expressly state in one form or another that stock dividends are not subject to tax. In nineteen of these states the exemption is made by the device of excluding stock dividends from taxable dividends.<sup>63</sup> In four

<sup>61</sup> The amendment was passed in 1926 and made retroactive as of January 1, 1919, the effective date of the Act being changed, and reads as follows:

"Sec. 1. The word 'dividend' means any distribution made by a corporation out of its earnings or profits . . . in cash . . . property or in stock of the corporation, other than stock dividends as herein defined. 'Stock dividends' means new stock issued, for surplus or profits capitalized, to shareholders in proportion to their previous holdings."

"Sec. 2. Stock dividends when received by a stockholder shall not be subject to tax . . ."

<sup>62</sup> *People Ex Rel Clark v. Gilchrist*, 243 N.Y. 173, 153 N.E. 39 (1926).

<sup>63</sup> See Part 1 of table below.

	Tax on Corpo- rate In- come	Tax on Per- sonal Income	Tax on Corpo- rate and Per- sonal Income
Part 1: 1. Alabama	1. —	1. —	1. X
2. Arizona	2. —	2. —	2. X
3. California	3. —	3. X	3. —
4. Delaware	4. —	4. X	4. —
5. Idaho	5. X	5. —	5. —
6. Indiana	6. —	6. —	6. X
7. Kentucky	7. —	7. —	7. X
8. Louisiana	8. —	8. —	8. X
9. Massachusetts	9. —	9. X	9. —
10. Minnesota	10. —	10. —	10. X
11. Montana	11. —	11. X	11. —
12. New Hampshire	12. —	12. X	12. —
13. New Mexico	13. —	13. —	13. X
14. New York	14. —	14. X	14. —
15. Tennessee	15. —	15. —	15. X
16. Utah	16. X	16. X	16. —
17. Virginia	17. —	17. —	17. X
18. West Virginia	18. —	18. X	18. —
19. Wisconsin	19. —	19. —	19. X

states of the group the exemption is effected by excluding stock dividends from the definition of gross or net income.<sup>64</sup> In three of the states the tax basis employed is that of the federal law.<sup>65</sup> In three of the states the law is silent but the regulations issued thereunder exclude stock dividends from taxation.<sup>66</sup> One state statute specifically declares dividends in stock are subject to tax, but the regulation exempts such dividends.<sup>67</sup> Two states have respectively two separate laws for taxing corporations and individuals, with differently worded provisions for exempting stock dividends from the tax.<sup>68</sup> The provision for exemption or exclusion in most of the foregoing statutes is brief, and no attempt is made by most of them to define stock dividends. The statutes of four states and the regulations of three other states do, however, attempt to define the type of stock dividend exempted or excluded.<sup>69</sup>

Six states have tax laws which neither specifically exclude nor include stock dividends as taxable income.<sup>70</sup> Five states in this group refer simply to "dividends" which

Part 2: 1. California	1. X	1. —	1. —
2. Iowa	2. —	2. —	2. X
3. Kansas	3. —	3. —	3. X
4. South Dakota	4. —	4. —	4. X
Part 3: 1. Connecticut	1. X	1. —	1. —
2. Pennsylvania	2. X	2. —	2. —
3. Tennessee	3. X	3. —	3. —
Part 4: 1. Oregon	1. X	1. X	1. —
2. Missouri	2. —	2. —	2. X
3. Arkansas	3. —	3. —	3. X
Part 5: 1. Mississippi	1. —	1. —	1. X

<sup>64</sup> See Part 2 of table in note 63.

<sup>65</sup> See Part 3 of table in note 63.

<sup>66</sup> See Part 4 of table in note 63.

<sup>67</sup> See Part 5 of table in note 63.

<sup>68</sup> The states are California and Tennessee. See table in note 63.

<sup>69</sup> The states are as follows: Alabama, Montana, New York, and West Virginia. The statutes referred to in these states involve personal income tax, except that for Alabama, which covers corporations as well.

The definition in all of the foregoing states is typified by the following from the Alabama law:

"The term 'stock dividend' means new stock issued for surplus or profits capitalized, to shareholders in proportion to their previous holdings."

Substantially the same definition is incorporated in the regulations of the following states: Iowa (covering both personal and corporate taxes), Kansas (one law for personal and corporate tax) and Oregon (covering both personal and corporate taxes).

<sup>70</sup> Either no regulations are issued or if issued they are silent on the point.

are held subject to tax.<sup>71</sup> One state has two separate laws for taxing corporations and individuals, with the one relating to individuals making "dividends" taxable only when received from a foreign corporation.<sup>72</sup> One state uses the federal law as the basis for

<sup>71</sup> The states are given below.

	Tax on Corporate Income	Tax on Corporate and Personal Income
1. Montana	1. X	1. —
2. New York	2. X	2. —
3. South Carolina	3. —	3. X
4. Georgia	4. —	4. X
5. Vermont	5. X	5. —

<sup>72</sup> Vermont. As to the law pertaining to individuals, the amount of tax on "dividends" received from a foreign corporation is reduced in proportion to the income tax paid by the distributing corporation to the local state.

taxing corporate income, but expressly adds that "dividends" are subject to tax.<sup>73</sup>

The laws of four states expressly tax stock dividends along with other types of dividends.<sup>74</sup> Other parts of the respective statutes, however, exempt dividends including stock dividends from taxation if the distributing corporation is a domestic one, and reduce the amount of the tax on the dividends where the distributor is a foreign corporation but pays tax to the local state on a portion of its income. Stock dividends are thus taxable as income in these states under the circumstances alluded to.

<sup>73</sup> Massachusetts.

<sup>74</sup> The states are: Maryland, North Carolina, Oklahoma and North Dakota. Each of these states has one income tax law covering both individuals and corporations.

## THE ACCOUNTING EXCHANGE

### EXPLAINING ANNUITY FORMULAS

THE MATHEMATICIAN has kept his secret well hidden from the layman. The latter hardly dares to enter the dark and uncertain chamber so well filled with abstractions, symbols, and complex formulas. An example is the usual explanation of the two principal annuity formulas which is found in nearly every textbook on mathematics of finance.

The student is told that the rents, in the amount of an annuity, will accumulate to amounts which constitute a geometric progression. To derive the formula for the amount of an annuity, he must employ the formula for the sum of a geometric progression. It is assumed that he will look for the latter elsewhere in the book, that he will follow the several algebraic steps by which it is derived, and that he will understand the substitution necessary to obtain the one formula from the other.

Similarly, the student is told that the present worths of the several rents, in the present worth of an annuity, constitute a geometric progression. To derive the formula for the present worth of an annuity, he must employ the formula for the sum of a geometric progression. Here he has as much difficulty as in the other case.

The two principal annuity formulas can be explained without reference to a geometric progression and in terms that a student can understand and remember. The formulas for annuities with rents at the end of the periods are as follows:

$$1. \text{ Amount of an annuity: } A = R \left[ \frac{(1+i)^n - 1}{i} \right]$$

$$2. \text{ Present worth of an annuity: } PW = R \left[ \frac{1 - \frac{1}{(1+i)^n}}{i} \right]$$

Notice that the numerator in the first formula is compound interest on one and that the numerator in the second formula is compound discount on one. Without reference to a geometric progression, the author

will attempt to show why the first formula is compound interest on one divided by the interest rate per period and why the second formula is compound discount on one divided by the interest rate per period. It is assumed that the student already understands the formulas for compound interest and compound discount and recognizes them in the above formulas.

First, assume that a man places one dollar in Bank A and leaves it there six years at four per cent compound interest. At the end of the time the compound amount will be \$1.2653. He also places four cents a year in Bank B for six years, and the annuity earns four per cent compound interest. At the end of the time the amount of the annuity in Bank B will be \$0.2653, because the four cents placed in Bank B each year will earn the same interest as the four cents earned each year on the one dollar in Bank A. If both the amount of the annuity and the rent in Bank B are divided by 0.04 (which is the same as multiplying by 25 so as to increase the size of the annuity) to have an annuity of one dollar each year, the result will be as follows:

$$\begin{array}{l} \text{Amount of an annuity: } \$0.2653 \div 0.04 = \$6.6325 \\ \text{Rent: } \$0.04 \div 0.04 = \$1.00 \end{array}$$

Obviously the interest on the one dollar in Bank A—that is, \$0.2653—divided by 0.04 gives the same result as in the one line above, \$6.6325, the amount of an annuity of one dollar for the same rate and time. Thus, the interest on one dollar divided by the interest rate gives the formula for the amount of an annuity of one. The explanation may be summarized in the following manner.

BANK A	
\$1.00.....	\$1.2653
BANK B	
\$0.04.....	\$0.0487
\$0.04.....	0.0468
\$0.04.....	0.0450
\$0.04.....	0.0432
\$0.04.....	0.0416
\$0.04.....	0.04
	<hr/> \$0.2653

$$\frac{\text{Amount:Rent}}{0.2653 : 0.04} = \frac{\text{Amount:Rent}}{x : 1}$$

$$x = \frac{0.2653}{0.04} = 6.6325$$

Secondly, to arrive at the explanation of the present worth of an annuity of one formula, assume that a man places \$0.7093 in Bank A and leaves it there six years at four per cent compound interest. As \$0.7903 is the compound present worth of one dollar, when the interest rate per period is four per cent and the number of periods is six, the \$0.7903 will amount to one dollar at the end of the time. The difference of \$0.2097 is the discount on one dollar. He also places in Bank B \$0.2097 in six separate accounts that earn four per cent compound interest as follows: \$0.0384 in the first account which is to be closed after one year, \$0.0370 in the second account which is to be closed after two years, \$0.0356 in the third account which is to be closed after three years, and so on as in the summary below. At the time that each account is closed, four cents will be available, as the present worth of four cents for various lengths of time were placed in each account. Thus the man's dealings with Bank B constitute an annuity, the present worth being \$0.2097 and the rents four cents each. If both the present worth of the annuity and the rent in Bank B are divided by 0.04 (which is the same as multiplying by 25 so as to increase the size of the annuity) to have an annuity of one dollar each year, the result will be as follows:

$$\begin{aligned} \text{Present worth of an annuity: } & \$0.2097 \div 0.04 = \$5.2425 \\ \text{Rent: } & \$0.04 \div 0.04 = \$1.00 \end{aligned}$$

Obviously the discount on the one dollar in Bank A—that is, \$0.2097—divided by 0.04 gives the same result as in the one line above, \$5.2425, the present worth of an annuity of one dollar for the same rate and time. Thus, the discount on one dollar divided by the interest rate gives the formula for the present worth of an annuity of one. The explanation may be summarized in the following manner.

BANK A	
\$0.7903.....	\$1.00
BANK B	
\$0.0384.....	\$0.04
0.0370.....	\$0.04
0.0356.....	\$0.04
0.0342.....	\$0.04
0.0329.....	\$0.04
0.0316.....	\$0.04
\$0.2097	

$$\text{Pres. Worth : Rent} = \text{Pres. Worth : Rent}$$

$$0.2097 : 0.04 = x : 1$$

$$x = \frac{0.2097}{0.04} = 5.2425$$

The author believes that these explanations are preferable to the usual textbook discussion. The student can see why the annuity formulas are as they are; namely, compound interest on one divided by the interest rate per period and compound discount on one divided by the interest rate per period.

J. DONALD WATSON

## BOOK REVIEWS

*Twenty-Five Years of Accounting Responsibility—1911–1936.* George O. May. (New York: 1936. Pp. xiii, 368; vii, 376. \$3.00.) American Institute of Accountants.

The appearance of this book is an outstanding event in the history of accounting literature. It cannot fail to add to the stature of the accounting profession in the eyes of all who are interested in the sound development and progress of our political, social, and economic life. Not only the breadth of the subject matter, but also the breadth of spirit in which it is treated, will command respect. Already one hears from others than accountants—indeed from some not very sympathetic toward accounting—comment expressive of the regard engendered by this book for its author's broad grasp of, and penetrating insight into, the larger business and economic problems of our time. The book is written in lucid, cogent style, interspersed with witty phrase, apt simile, and occasional literary and scriptural allusion, and is pervaded by that serenity of spirit which Matthew Arnold tells us is an attribute of all true greatness.

Although most of the articles have already appeared in the periodical literature of the last 30 years, the effect of bringing them all together in one place is impressive. Attentive readers of accounting literature can scarcely be ignorant of Mr. May's general views, and in this respect will encounter few surprises from anything in the book; but they can scarcely fail to be struck with the vigor and completeness with which those views are expressed, the compelling logic brought to their support, and the consistency with which they have been held over a long period of years.

It is difficult to give an idea of the variety of subject matter here dealt with. The table of contents occupies five pages, and no better general impression can be given than that afforded by the titles to the seven parts into which the work is divided: The Profession of Accounting, Depreciation, Valuation, Regulation of Securities, Taxation, The Influence of Accounting on the Development of an Economy, and Reviews and Criticisms. Thus the book makes a progress from the domestic problems of the public accounting profession to the larger aspects of economic activity, and no discussion of its specific subject matter can be more than representative.

Speaking of the responsibilities of auditors, Mr. May insists that these must be judged in the light of the purposes to be served. He argues (I, pp. 6, 7) that a prospectus is in some respects a more exacting occasion than an annual report, so that the former requires more specific and detailed expression of the auditor's opinion than might be necessary for the latter. With the earlier part of this view the Securities and Exchange Commission might be said to be in general accord, as evidenced by the character of Form A-2 as compared with Form 10. Probably, however, they would be somewhat reluctant to forego anything needed for a complete expression of opinion, even in Form 10, their general

view being that since the auditor's principal function is the expression of an independent opinion, nothing less than a full statement of all the points at variance between himself and the company would satisfy. But this view underestimates the extent to which qualification and dissent in the certificate may confuse the picture. As in Byron's gibe at Coleridge:

Explaining metaphysics to the nation—  
I wish he would explain his explanation.

so the auditor is often disposed to feel that his qualification would itself need some further qualification to be strictly true, by which time the reader might be better off with the original unqualified statement. But the Commission's criterion will necessarily be that of material fact; both under the Securities Act and the Exchange Act it will be disposed to insist upon an expression of opinion whenever it considers a material fact to be involved.

Mr. May recommends the English practice of appointment of auditors by stockholders; his reiteration of this in 1915 (I, p. 27), in 1926 (I, p. 47), and in 1932 (I, p. 100) is noteworthy. He feels, as do most people who have had experience with English practice, that here is the stockholder's most effective means of self-defense. There are, however, among Englishmen themselves those who see some disadvantage in the practice, in that an auditor appointed by company officers, or by a board of directors, is in a more definite and manageable situation than one appointed by a large body of stockholders. Presumably Mr. May would reply that the auditor's duty to the stockholders is the same whether the appointment be made by them, by the officers, or by the board, and that appointment by the stockholders constitutes a better basis for performing that duty.

Many pages in this book illustrate the extent to which Mr. May has anticipated the subsequent course of events. Writing in 1926, in connection with a discussion of Professor Ripley's famous article criticizing corporation accounting practices, he anticipates "some sort of bureaucratic control" over them (I, p. 42). All through the book run the concurrent *leitmotifs* of (1) the responsibilities of accountants for public reporting, (2) the difficulties in the way of adequate reporting, and (3) the danger that remedies applied to admitted evils may be worse than the original disease, especially in respect of the burdens they place upon the innocent, and the obstruction they offer to the healthy, normal development of trade. Perhaps "they that are whole have no need of a physician, but they that are sick"; but when the medicine is passed around, the conscientious ones are likely to get more of it than the others, with results not always for the general good.

In the same spirit is the conclusion passed upon The Royal Mail case that "though the individuals were clearly entitled to acquittal, the system must be condemned and must be changed" (I, p. 76). This is one of those profound observations applicable to many situations in history; Charles I and George III are

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notable examples of the folly of endeavoring to perpetuate systems which have outlasted their general acceptance and usefulness. Though Lord Kylsant's offenses were less heinous than theirs, they were all alike in being the victims of the onward march of progress. Few people on this side of the water will wish to disagree with Mr. May's view that secret reserves, as known in England, are not consonant with the doctrine of full disclosure implied in the public financing of business corporations.

Purists in technical style will be disposed to fall foul of Mr. May in respect of his terminology on the subjects of depreciation. He rejects (I, p. 167) the proposal to substitute the term "allowance for depreciation" for "reserve for depreciation"; he denies (I, p. 164) that a reserve is necessarily an appropriation of net profits; it may be an appropriation of gross profits. He speaks (I, p. 160) of charging expenditures for renewals against "the fund," meaning the depreciation reserve account. A number of academic writers have sought to erect these practices into high crimes and misdemeanors, but Mr. May simply uses the common language of business leaders and others accustomed to look at the things themselves, without too much hindrance from the technical procedures of accounting. Speaking of pedagogy, however, teachers of accounting will be delighted with the dramatic effect with which the statement of the source and application of funds is used to present the final summaries of the ill-fated Krueger and Toll ventures (I, p. 108).

Disputes about terminology are pointless until it is recognized that men working in the practical field have one problem, and teachers in the classroom have another. The former group consists largely of mature and experienced men, many of whom understand pretty thoroughly the various aspects of a subject like depreciation. They talk substantively of the facts of depreciation, of their financial effects, of the provision for them, and of the resulting funds, without any attempt to follow strictly what Professor Allyn Young used to call "the arbitrary categories of accounting." These practices certainly play havoc with a teacher's efforts to explain these phenomena in precise terms to the elementary minds of college students, and every accounting teacher is forced to resort to his own devices for keeping these classifications clear; but pedagogical exigencies scarcely justify him in telling the veteran practitioners that they do not know what they are talking about. The accounting teacher's problem is analogous to that of the teacher of chemistry, who must lay a foundation of inorganic before he can do much with organic chemistry; accounting in real life resembles the latter much more than the former in that the elements with which it details are seldom found in a pure state.

In Parts II and III Mr. May threads his way through the thorny questions of depreciation and valuation, discussing their application both in the industrial and in the public utility field. He points out the logical conflicts of the several theories developed by the courts and regulatory bodies, carrying these theories to their inevitable conclusions with relentless logic. These are among the most arduous portions of the book, into

which nobody should venture without being prepared to give sustained attention to close reasoning. In different places the author may seem to be accepting contradictory ideas, when he is in fact only pointing out, not necessarily with approval, the logical consequences of the different theories. In particular he draws out clearly the confusions which arise between depreciation as a factor in accounting on the ordinary business basis and depreciation as a factor in rate-making; between depreciation as an element in income determination and depreciation as it may or may not affect the value of assets. Certainly no professor of accounting, and no practising accountant, can reach conclusions on these issues which he can regard as final until the U. S. Supreme Court, the Interstate Commerce Commission, the Federal Communications Commission, and other bodies have arrived at more harmonious views on such fundamental concepts as "prudent investment" and "present fair value." When within the Supreme Court itself we find Mr. Justice Brandeis as the chief protagonist of the prudent investment theory, and Mr. Justice Hughes the author of the famous dictum, "It is that property, and not the original cost of it, which is protected by the Constitution" (Minnesota Rate Cases, 230 U.S. 454), thus laying down an apparently inescapable basis for present value, then lesser mortals cannot but tread with due humility. These problems are discussed with a broad sweep, not only in the sections mentioned, but also later in the book, as the third chapter under the title "The Influence of Accounting on the Development of an Economy." Departing altogether from technical accounting considerations, Mr. May points out that for many years the country wanted railroads and wanted them badly enough to be almost indifferent to the cost; that from the revenues available from the meagre traffic of pioneering years it was not possible to make the appropriations demanded by straight-line depreciation and still show a net return upon investment; that such a result would have discouraged the financing, and therefore the construction, of the roads which were being demanded, and therefore straight-line depreciation was not practically possible. The only basis on which this logic can be attacked is to argue, as some do, that the interests of the country would have been better served by a slower and more deliberate development, but at best this is an *ex post facto* type of argument. The fact remains that the leaders of those days adopted accounting principles conducive to the construction of railroads, and probably the losses to investors were greatly outweighed by the gains to the community at large. Whether the accounting reports of those days practised "full disclosure" for the benefit of the investors who provided the money is another question, which would now be more insistently asked than it was then.

The influences of accounting upon internal management are well illustrated in the discussion of the Good-year reorganization of 1920 (I, pp. 291-316). The company management prior to the reorganization was characterized as being good in manufacturing, in selling, and in general development, but weak in the controls of purchases, of finance, and of accounts. The resulting

management was "a fair weather sailor," unable to navigate when a real wind was blowing, the similes being pointed with classical allusions to Horace.

The last item in the book, a letter to J. M. Keynes pointing out certain fundamental discrepancies in one of the tables in his work, *The General Theory of Employment, Interest, and Money*, well illustrates the range of Mr. May's interests. The table related to computations of the net increase in investment in the United States, after deductions for decreases from maintenance and depreciation. Mr. May observed that these deductions were not on the same footing as the gross totals from which they were subtracted, and in a note in *The Economic Journal* (London) for September, 1936, Keynes accepted this correction.

One series of papers (II, pp. 49-123) deals with the regulation of securities, and brings out certain aspects of that problem which in these days tend to be minimized, if not overlooked. He emphasizes the desirability, from the point of view of the public good, of a free flow of capital into industry; he points out the inevitable dangers inherent in industrial investment, and the disappointments which must follow too high hopes of eliminating them. But he recognizes the need for progress, and few men have done more to promote it along sound and practical lines.

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*Cases on Business Law.* Dwight A. Pomeroy. (Chicago: South-Western Publishing Company. Pp. xxxiv, 1361.)

This book represents an attempt to adapt the case method of teaching law to present day conditions in the field of business law. "It is believed that such disadvantages as may have been found in the study of cases may, for the most part, be eliminated by a better selection of cases for study, by a more logical arrangement of the cases, and by other aids that may be given to the student. In accordance with this theory, this book has been prepared to assist students in understanding not only important principles of law but also a wide variety of applications of each principle." The cases chosen are modern cases. In each instance brief facts of the case are placed above the name of the person writing the opinion, thus shortening the whole case to a page of two. Principal cases are followed by questions designed to aid the students in gaining a mastery of the cases and also by additional cases in problem form.

The chapters of the book are: 1. Contracts; 2. Agency; 3. Employer and Employee; 4. Negotiable Instruments; 5. Suretyship; 6. Insurance; 7. Bailments; 8. Carriers; 9. Sales; 10. Partnership; 11. Corporations; 12. Property; 13. Deeds of Conveyance; 14. Mortgages; 15. Landlord and Tenant; 16. Torts; 17. Business Crimes.

Each chapter is carefully divided into from four to nine parts each of which is in turn separated into properly headed divisions. This arrangement is "to indicate to the student where he is going and what he should look for while on his way." A capable teacher should find

this book a very satisfactory means of imparting the principles of business law to students.

ARTHUR W. HANSON

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*Municipal Accounting Statements.* National Committee on Municipal Accounting. (Chicago: 164 pages—58 forms—cloth bound. \$2.)

This volume is the sixth publication of the National Committee on Municipal Accounting. It includes, in great part with some refinements, the material published in the previous five bulletins. The type of work being done by this committee in publishing such a work as this is of the utmost value. A need is filled here that is available in no other single place as far as your reviewer is aware. It is a well known fact that the records of many municipalities are inadequate to display the facts as they should be. In the past it has been impossible in many cases for the municipal officials, having no particular accounting knowledge, but being desirous of improving their records, to find without great expense what those records should show. How results should be displayed correctly is one of the features of this book.

The most commendable feature of the volume is that on municipal terminology. In the past the terminology for municipal accounting has been woefully vague. The general problem of terminology has been recognized by the American Institute of Accountants, but the efforts of the National Committee on Municipal Accounting are no less commendable. Certainly it is recognized that no general advancement can be made until municipal terms are understandable. It may be stated without hesitation that this section of the volume is of prime importance regardless of its location in the book.

The remaining four sections of the bulletin follow each other in a definite, well defined sequence, discussing respectively principles underlying the preparation of a municipal financial report, the report proper, a discussion of each fund and its statements, and an explanation of accounts. The first of these sections sets forth some fifteen principles to be followed in preparing a financial report for a municipality as well as discussing the general contents of a report and its purpose. The cash and accrual basis of accounting are discussed with the accrual basis being recommended "in so far as practicable." This shows the recognition of the fact that the accrual basis is not always a practical possibility.

The presentation of the statement forms proper takes up the majority of the book as far as space is concerned. It illustrates profusely all sorts of municipal reports classified by funds. Each of the nine kinds of funds recommended by the committee has illustrated for it the statements and reports relative thereto. These statements are complete, giving illustrations for almost any imaginable situation. With amounts being used in the various statements which are keyed to relative amounts in other statements the value of this section is greatly increased for reference purposes.

The following section is made up of a detailed dis-

cussion of the various funds and statements illustrated in the previous section, while the remaining part is an alphabetical list of accounts used in the statements with an adequate explanation of each.

This book is one of the most encouraging publications along the lines of advancement in municipal accounting that has been met for some time. Its scope of contact is great. It is not a textbook. It is a guide book that every municipality should be using in order to improve its usefulness as a servant of the people. It has great value for illustrative and reference purposes in the college and university class studying municipal accounting. The public accountant will find this volume useful in conjunction with the publication on municipal audits by this committee in advising and auditing for municipalities. The layman can refer advantageously to such a volume to determine what his municipality should be telling him and to understand better the terms used in connection with its operation.

The National Committee on Municipal Accounting has done a good piece of work filling a great need. Let us hope that they continue and that they recognize their job is not finished until every municipality in the country has an adequate and understandable accounting and reporting system. That is a difficult task, not to be accomplished in a few years, but certainly it is a commendable object.

ROBERT PHILLIP HACKETT

University of Illinois

*Accounting Principles for Engineers.* Second Edition. Charles Reittel and Clarence VanSickle. (New York: McGraw-Hill Book Company, 1936. Pp. viii, 518. \$4.00.)

This is a second edition of a book formerly published under the title of *Cost Finding for Engineers*. The only real change is the substitution of a new set of problems at the end of the book. The text is unaltered except for the deletion of a very few scattered paragraphs and the addition of an equally small number of new short sections. The new title appears only on the cover and title page; the old title is retained unchanged on every page heading. Two inserted forms in the older book are omitted, but without deletion of test references to them and without renumbering of subsequent forms.

W. P. FISKE

Massachusetts Institute of Technology

*Accountants' Index.* Fourth Supplement: A Bibliography of Accounting Literature, January, 1932-December, 1935. (New York: American Institute Publishing Company, 1936. Pp. 503. \$10.00.)

In this volume the American Institute of Accountants has continued its good work in the compilation of a complete accounting bibliography down to the end of 1935. It is perhaps a reflection of the change in business conditions that the Introductory Note speaks of the enterprise with more confidence than appeared in the volume of 1932; now the Institute regards the Index as a "necessary service to the profession," and there should be no question of the continuance in perpetuity of this compilation.

One is again struck with the completeness and ac-

curacy of the work, evidencing the painstaking care with which it has been put together. Nothing is wanting in the contents, and very little indeed in the manner in which they are presented. It would be in the general interest that the work should be better known, not only among accountants, but among others who find a more occasional yet none the less substantial interest in accounting. I have recently, with much satisfaction, been able to introduce to this work two or three economists who have come to feel that much can be learned from the accounting field of the manner in which business is carried on and economic movements are developed. Furthermore, an acquaintance with this Index, aggregating 4104 pages for the five volumes, would be a helpful experience for the jurist of some eminence who remarked that, while he had to participate in trials involving questions of property valuations, income determination and the like, he "did not know that a literature on that subject existed."

Depreciation is still easily the first of all the topics listed, in point of the space occupied; thirty-two pages are devoted to this subject as compared, for example, with twenty-six pages of citations on Accounts, Accountants, and Accounting. This is due not only to the number of the citations on depreciation, but also to the fact that numerous actual depreciation rates have again been quoted. In fact, depreciation seems to be the only topic on which substantive information is given, citations alone being furnished on all other titles. It is an open question whether, as a matter of convenience, it might not some day be worth while for the Institute to publish this collection of depreciation rates in a separate volume, perhaps retaining the citations in the Index.

The mark of the New Deal lies across this volume, under such titles as National Recovery Administration, Codes, and Securities Act. The citations under the last-named of these subjects strike one as peculiarly scanty, and a little investigation brings to light a problem in cross-citations which must be a perpetual difficulty to the editor; for under the names of individual authors one can find references to a considerable number of articles on this topic not listed under the topic itself. Many other articles are listed both under the topic and under the author, and one wonders why the distinction. Also, since Form 10 and Form 10K are listed under Securities and Exchange Commission, why is Form A-2 not listed?

One touch of sadness comes from seeing on the same page the names Arthur Lowes Dickinson and Lawrence Robert Dicksee as authors. Both of these men have in practice, writing, and teaching had great influence of international scope, but their voices will be no longer be heard among us; both have passed away during the period covered by this volume.

T. H. SANDERS

Harvard Graduate School of  
Business Administration

*Accounting Fundamentals.* First edition. George A. MacFarland and Robert D. Ayars. (New York: McGraw-Hill Book Company, 1936. Pp. xv, 667. \$4.00.)

"This text is the result of many years' experience in teaching accounting. The authors have conducted

first-year courses under a number of plans of development and have used various textbooks. They have had thousands of students in elementary accounting from the school of business, hundreds from the college of liberal arts and from the engineering and other schools, and thousands in evening classes.

"It has been the experience of the authors that, regardless of the classification of the student, the greatest interest in the subject and the most rapid and soundest development are obtained from a course which follows an outline similar to that of this book."

"This textbook is designed to meet the needs of the laboratory or non-laboratory, full-year, elementary course. The use of accounting data as a factor in the control of an enterprise is emphasized but the methods of collecting the data are not neglected. Unnecessary duplication of subject matter is avoided. The various subjects are arranged by chapters to succeed each other in logical order and are tied together to give both unity and clarity to the book."

Valuable questions are found at the end of each of the thirty chapters. All problems are in the back portion of the book beginning on page 403. The first nine chapters which cover 105 pages, exclusive of problem material, teach the fundamentals of bookkeeping. These chapters explain (1) the significance of and need for accounting; (2) the basic equation of the balance sheet, seven sections of the balance sheet and the contents of each, and the form, object, and use of a balance sheet; (3) the causes and effect in changes in net worth; (4) the profit and loss statement as to form, purpose and terminology; (5) the rule for increase and decrease of various kinds of accounts, the construction of accounts and ledgers, and the application of double entry bookkeeping; (6) the use of the usual two column journal and posting to the ledger accounts; (7) then the use of additional journals as books of original entry; and (8) then we have the preparation of the trial balance and some helps as to finding errors in the trial balance.

Chapter X is rather short but still complete in the explanation of capital and revenue expenditures. Adjusting the books is the next chapter. The setting up of the new inventory figure by a credit to Cost of Goods Sold is the first adjustment shown. You will find illustrations of adjustments for deferred charges, deferred credits, accruals payable, accruals receivable, depreciation of fixed assets and the estimate of loss on bad debts. This chapter concludes with a complete adjusted trial balance. In chapters XII and XIII we find the closing procedure, ruling the ledger accounts, and preparation of a post-closing trial balance, a ten column working sheet and a balance sheet and profit and loss statement. Then again in the next two chapters we find a more complete treatment of inventories, accruals, deferred items, bad debts and depreciation than the explanation in Chapter XI. In these same two chapters, XIV and XV, re-adjusting entries are defined and a rather full explanation of obsolescence and depletion is given with entries explaining their treatment on the books. Two chapters are devoted to business papers and practices. Some of the more common and important items are promissory notes, interest and discount, drafts, trade acceptances, various papers used in

purchasing, bills of lading, cashier's checks, certified checks, bank drafts, and bank reconciliation. Controlling accounts with subsidiary ledgers, columnar journals, petty cash systems, voucher system, and auxiliary records as insurance register, notes receivable register, and plant ledgers are discussed in three more chapters.

The very important subject of partnerships is well handled in two chapters. The study of partnerships includes formation, goodwill, dissolution, and liquidation. The subject of corporations is divided between three chapters. Both par and no-par stocks are in the explanations given. A description of various classes of bonds, the use of manufacturing accounts and preparation of financial statements for a manufacturing concern, a complete explanation of the voucher system and the analysis and interpretation of financial statements comprise the four concluding chapters.

The problems and materials for the practice work are practical and understandable by the students and this text should be considered carefully by all who are interested in the first year accounting work.

W. E. KARBENBROCK

University of Illinois

*Auditing Laboratory Set.* Thomas W. Byrnes and K. Lanneau Baker. (New York: The Ronald Press Company. \$3.50.)

In this work we find what to the lay public probably represents the chief, or at least the most distinctive, feature of the accountant's work. The accountant as a checker or snooper has been glorified or condemned, as the case may be, both in song and story. To judge a laboratory set in auditing, therefore, is quite a task. There is generally no difficulty in arousing or keeping the interest of the students in auditing courses; and this interest is at its maximum when the laboratory work is started, because of the belief that the set as nearly as may be duplicates conditions found in practice. The student feels that here he is surely "getting his money's worth" in that he is told the exact procedure of when, where and how to conduct an audit. In this respect the authors have admirably succeeded. The stimulation of actual working conditions is perfect, since the material has been taken from a going business.

"The principal objective is to guide the student in the various steps usually followed in actual practice. If would, of course, be well nigh impossible to obtain a set of books and records which would in the short period reviewed contain all of the errors of omission and commission, irregularities, defalcations, etc. that are included in this set; therefore many such items have been inserted to acquaint the student with the methods of the fraudulently inclined, and yet permit the completion of the audit within a limited period of time." (Quoted from Preface.)

And yet even though the practice set duplicates field experience, there is a danger. It is a danger inherent, to some extent, in all courses employing practice sets. The emphasis perforce is on technique, on the mechanics of achieving a given result; and thus the result may be attained with a minimum demand on the student's analytical faculty. From the viewpoint of the

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instructor, the practice set assumes at times an importance not warranted by the course. In order to cover the necessary ground, an instructor may, when pressed for time, merely develop the laboratory set because it is an easy, mechanical job, and omit, or at least reduce the discussion concerning points of theory. If I have any general criticism to make of our schools of business, it is that by and large they have tended to develop efficient practitioners, at the expense of analytical depth, and capacity to see a problem from more than a surface point of view.

The present set in all that it claims to be. With great patience the authors have assembled a complete set of books, together with supporting documents. Here we find a mass of petty cash vouchers (unnumbered, unfortunately), cancelled checks complete with endorsements, notes, invoices, receiving reports, etc. Certainly it is desirable that students be furnished with material approximating conditions in the field, and on this point the authors are to be congratulated. As long as the practice work can be correlated with the theory, no fault can be found with this type of instruction.

THEODORE LANG

New York University

*Capital Surplus and Corporate Net Worth.* Raymond P. Marple. (New York: The Ronald Press Company, 1936. Pp. viii, 201.)

The developments in business from 1922 to 1929 and from 1930 to 1936 have emphasized the importance of many problems in accounting for net worth. There are significant differences between the two periods in the nature of those problems, but in both periods some of the most important problems dealing with net worth revolve about the concept of capital surplus, its sources and the different types of charges which may properly be made thereto. Dr. Marple's book is timely because he has recognized these facts and has presented an extensive and penetrating analysis of capital surplus as a central feature of corporate net worth.

In the first few chapters there is a sound exposition of the principle that legal requirements must be followed in accounting for capital and surplus, but that accounting has responsibilities extending beyond the mere meeting of legal requirements. The extent of legal capital should be displayed, but when actual capital is different therefrom, as in the case of stock sold at a premium, the accounting structure should be such that both the legal capital and the actual capital may be recorded.

This is illustrated in the discussion of treasury stock, Chapter 5, especially pp. 66-69. Actually the purchase of treasury stock is a return of capital, but legally it is a reduction of surplus, and in the typical legal rule the acquisition of treasury stock is limited by the amount of surplus. It is important that surplus be segregated to cover purchases of treasury stock in order that amounts thereafter available for dividends be accurately shown. This somewhat confusing subject is well handled.

Much of the book consists of quotations from the corporation laws of the several states. There is relatively little consideration of case law and of the fact that

the real effects of statutory principles are dependent on their interpretation by the courts. For this reason the legal analysis is scarcely exhaustive enough to serve as the basis for decisions by those who are dealing with capital surplus or who are advising clients in that connection.

The several corporation statutes are not a fruitful source from which to draw a cohesive body of principles with respect to capital surplus. This is illustrated by the treatment of stock dividends at pp. 161-166. The author shows that in the case of no par stock the amount charged to surplus for each dividend share may be equal to the prior stated value of the stock, less than that, or there may be no change at all, or the charge may be based on the fair value, presumably the market value, of the shares issued. Quotations are given from the statutes of several states to illustrate these provisions. The subject is then dropped as if this were the answer to the problem. There is no discussion of the serious effects which have followed from this looseness in the law, nor of the accounting principles which should govern in an area where there is no effective legal limitation. At many places in the argument reliance on statutes has induced somewhat superficial analysis.

At pp. 153 and 154 the following principle is stated, and is discussed at pp. 164-166.

1. It is proper to charge capital surplus for the following:

\* \* \* \* \*

(d) For capital surplus transferred to stated capital as the result of a stock dividend or by action of the board of directors.

(Of course, these charges are proper only if a sufficient capital surplus exists or is created for the purpose by the reduction of legal capital.)

This principle is of very doubtful validity. The payment of stock dividends from capital surplus was one of the unfortunate features of corporate policy just prior to 1929 and led to positive action by the New York Stock Exchange.<sup>1</sup> Neither the regulations of the Exchange nor the difficulties which led to those regulations are considered by the author in evaluating the validity of this principle. The parenthetical limitation on the principle is interesting. Would a stock dividend from capital surplus be wise if the surplus therefor were created by a reduction of capital?

This book recognizes and states most of the problems which arise in dealing with capital surplus, and has added measurably to the prior considerations of the subject. It seeks the reality of the subject in the provisions of statute law rather than in the policy decisions of corporations, but it clarifies many issues in a highly complex field.

W. A. HOSMER

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<sup>1</sup> "Report of the Special Committee on Stock Dividends," adopted by the Governing Committee of the New York Stock Exchange, September 11, 1929; "Further Announcement on Stock Dividends," adopted April 30, 1930.

*Deficits and Depressions.* Dan Throop Smith. (New York: John Wiley & Sons, 1936. Pp. vii, 264. \$2.50.)

This is primarily a study of the theory of unbalanced budgets but is, at the same time, a survey of a much larger field. The expenditures of the Government of the United States today are larger than at any previous peace-time in the history of this country. Moreover, these expenditures are taking new forms and are being pushed into new channels. The theory of the relations of government spending to business, banks, production and consumption which prevailed a decade ago is not adequate to encompass all these new types of depression expenditures. The methods of handling treasury funds have a new significance with relation to banks and the money markets. "Deficits and Depressions" includes an excellent chapter on war expenditures, war deficits, and their results, but the main emphasis in this work is on the deficits which arise in peace time and, more specifically, the deficits which arise because of depressions or through attempts to avoid depressions.

The study of depression deficits is attacked from three angles: (1) expenditures, (2) source of funds, (3) the repercussions of government spending. This approach is predicated on the assumption "... that customary powers will remain with the Federal Reserve System, and that normal procedures will be carried on as they have been in the past. Virtually all the material on the subject of unbalanced budgets has been based on the existing apparatus of central bank operations and money-market control." Thus some parts of this analysis are not strictly applicable to every phase of our present situation in that some parts of our commercial banking and central banking structure have failed to function during the period 1929-1936. To a certain extent this qualification is removed by a consideration of the last chapter which deals with the results of an unbalanced budget. However, the theory of depression deficits, as developed on the assumption of present banking and money market structures, is probably much stronger than would have been the case if all the current (and perhaps temporary) conditions had been included.

Government spending has, in the past, been conceived of as a matter of handing out purchasing power to be used. The exact method of spending has not been considered important. "Preference has been given to the various sorts of works or to direct relief, depending on the urgency of the projects." This has been one of the weaknesses of our spending program and it is from this point of view that the theory of spending is approached. "A more precise analysis yields objections to this assumption of the unimportance of the point of impact of the new spending. It is valid only if the economic system is rigid or, rather, taut. If there is any slack in the structure, the spiral of self-generative recovery may be broken. If there are stocks on hand to be disposed of, or debts to be paid at some place in the system, the new funds may run to waste, in that they do not induce an upswing." It is these conditions which the author describes as "time-lags in the supposedly integrated process of spending and production." We do not have de-

pressions unless some one or more of these relationships of production-consumption, saving-investment are out of balance. Which is the precise relationship considered responsible for the depression is a matter of business cycle theory but is very important from the standpoint of government spending. The haphazard spending of government funds without reference to the part such funds play in correcting or aggravating the causes which produced the depression can only be justified on the grounds of expediency, social need or humanitarian principles.

It is difficult to prophesy, in advance, how funds spent in a particular manner will be used. If paid to individuals, they may be spent for goods, accumulated as balances, or used to pay debts. If paid in a manner which benefits particular industries the funds may simply be used to reduce stocks. All of these results may be necessary to restore business to a healthy condition but the direct purchase of goods is the only one which can react directly on the problem and the reaction here may be only to reduce stocks. "To ignore the variable effects of different sorts of outlays is to assume what might be called a general diffusion theory of expenditure, and general diffusion theories in economics, at the best, neglect the very important factor of time, which, in a practical program, cannot be neglected with safety."

Government expenditures have largely been of the kind usually described as public works, and these expenditures are subject to all the qualifications mentioned above. Other types of spending may be for the purpose of strengthening the banks and other financial institutions, which is in reality a phase of central banking, or may be designed to "remove causes of existing disequilibria, such as purchases of marginal land to improve the agricultural situation." The expenditures which had as their aim the strengthening of banks were emergency measures but can be used merely to support existing institutions or to "initiate a real loosening of bank credit"; when used in the latter sense "is somewhat better than open-market purchases, but runs into the same lack of sound borrowers that has made central bank policy ineffective."

Funds to be used for governmental expenditures may be secured in a variety of ways; the accumulation of cash surpluses; social insurance funds; hoarded currency; or treasury borrowing. Some of these funds represent "idle funds," some existing funds diverted to new uses, and some newly created funds. Here the author is interested in showing the connection between government spending and banking theories. The theories of Keynes and Hawtrey regarding budgets are presented for the purpose of showing that increased government spending may be consistent with two very different banking theories. "The really crucial problem is that of associating the total amount of credit outstanding, which may be increased by bank loans to the Treasury, with the total spending, and, if possible, the direction of that spending."

Certainly prior to 1929 there was, in the United States, a very strong popular fear of unbalanced budgets. Since 1929 our Federal Government has, in one

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guise or another, been generally operating with an unbalanced budget. The present popular fear of unbalanced budgets is possibly not so great as the author assumes. However, this is a matter of opinion and as the author states "deficits have been viewed as portentous." Likewise, "If an unbalanced one is decided upon as either desirable or inevitable, it should not be approached with despair. If it is spoken of as a way out of the depression, public opinion may accept it as such and it may stimulate rather than destroy private activity." This is merely emphasizing the importance of public opinion as the subject of deficits. A spirit of optimism on the part of business men and bankers is more important than many of the indirect results of government spending such as reduced interest rates and temporarily increased purchasing power. When individuals have a pessimistic view of future conditions or policies low interest rates and enlarged sales will not be sufficient to cause them to expand plant and equipment and increase stocks on hand. This is likewise true if, due to continuing deficits, individuals anticipate inflation. Under such conditions funds may be spent it is true, but as the author emphasizes, these purchases will be of goods suitable for hoarding or equities which have possibilities of appreciation, rather than of plants and equipment.

Depressions, with declining prices, result in the reduction of inventories, and an increase in bank balances. To a certain extent the increase in bank funds follows from the reduction of inventories and the two changes may be due, indirectly, to the spending activities of the government. However, another factor is important here, namely, the reduction in maintenance of plants and the recovery of depreciation charges included in the selling price with no corresponding expenditures for capital goods. This factor is merely mentioned but may well be of great importance in permitting the building up of bank balances during a depression. However, the spending activities of the government which react on the liquidation of inventory likewise make possible the recovery of depreciation charges. These factors and policies are all closely bound together.

"Deficits and Depressions" is not a survey of the present situation. Rather the present situation is used as a laboratory and present policies used as illustrative material. This is a theoretical analysis rather than a description of any particular period. The analysis is keen and penetrating and while it is hard reading in places, it is a thoroughly competent piece of work.

F. P. SMITH

University of Rochester  
Rochester, New York

*Expenses and Profits of Food Chains in 1934.* Carl N. Schmalz. (Boston: Harvard University Bureau of Business Research 1936. Pp. vi, 50. \$1.00.)

This bulletin is the third of a series of studies of the expenses and profits of food chains. Previous bulletins covered expenses and profits from 1929 to 1933. In the present study a thorough analysis is made of various types of food chains including straight grocery chains, combination meat and grocery chains, and meat chains.

In addition data are supplied for the grocery stores, grocery sides, and meat sides of combination chains. Further analysis is made of the relationship of size of chain, size of city and sales per store to operating results. The usual tables of detailed dollar and percentage statistics of expenses and margins are given. These enable the reader to visualize the data from which the figures are calculated.

Many interesting conclusions and observations are made by Professor Schmalz both in respect to the data and in respect to business conditions which affected the data. For example, he points out that "the lower gross margins and lower expense rates of the straight grocery chains and the combination chains presumably were related in part, at least, to the relatively small size of the chains in these two groups, since previous studies have indicated that small chains—chains that perform fewer functions of a wholesale character, or in other words, do not represent so complete an integration of retail and wholesale functions—frequently have lower expense and lower gross margins than the large chains. In the case of combination chains, the low expense rates may be attributable in part to their relatively high sales per store.

"With regard to net profit and net gain, the average figures which are, of course, weighted by the relative size of the chains in each group, suggest that regular chains and combination chains proved distinctly more profitable in 1933 and 1934 than did the straight grocery chains or meat chains."

"In respect to net profit it is found that although a relatively high rate of gross margin is frequently one of the factors contributing to high profit rates, lower-than-average percentage expenses are much more likely to be a factor contributing to superior earning. Studies in other fields of retailing indicate the same conclusion for other types of retailers."

Profits for foods in 1934 were not particularly large; the average net profit was 0.59% of sales. Net gain was 2.21% of sales and 9.62% of net worth. All types of food chains averaged a net gain of at least a fraction of one per cent but only chains that operated combination stores or combination and straight grocery stores had a net gain of better than 1%. These chains averaged 2.28% and 2.02% respectively. No certain explanation is given for the greater success of these two types of chains. In general the combination chains had a relatively large volume of sales per store and the retail units were located in cities of moderate size. The chains with both combination and straight grocery outlets were among the larger chains and their net profit may be the combined result of large sales volume and superior management.

The current activity in consumer coöperatives makes the expense figures of chain groceries of pertinent interest. Grocery chains are among the lowest cost retailers and groceries are important in the field of coöperative retailing. Grocery chains may be used, consequently, as a standard in measuring the relative efficiency of coöperative stores in the grocery line. Grocery chains operate their retail outlets with an expense of around 15% of sales of which 9% is salary and wages. The cen-

tral division of a chain which exercises the management, buying, warehousing, transportation and financial functions has an average expense of approximately 6.5% of sales. Since these chains do their own wholesaling the foregoing figures mean that the combined cost of wholesaling and retailing food products is approximately 21.5%. A consumer coöperative will have to maintain a high degree of efficiency to meet their expense figures. Since net profit averages from 1% to 2% of sales and since many small coöperatives will not be able to buy as advantageously as the chains, it becomes apparent that the consumer dividends on food purchases will, at best, be small. If the coöperative movement continues to be of general interest and to grow, the current cost studies of various types of retail institutions will be most pertinent in judging their direct economic value.

EDGAR H. GAULT

University of Michigan  
School of Business Administration

*How to Evaluate Financial Statements.* Alexander Wall. (New York: Harper & Brothers, 1936. Pp. x, 319. \$4.00.)

This book, which contains a short, clear explanation of the method of analysis developed over many years by Mr. Wall for the use and benefit of bank credit men, he being secretary and treasurer of their organization, The Robert Morris Associates, is the successor to Wall and Duning's "Ratio Analysis of Financial Statements." It presents a thorough discussion of ratio analysis, the formulation of an index from the ratios, testing the ratios against those derived from common-size statements and ratios found to be common in the given business, and other related matters, many of which were dealt with in the earlier book, but are here given more advanced treatment in the light of further experience with them. The elucidation of method occupies the first 146 pages of volume.

The last half of the book is given over to the presentation of 15 specimen analyses of several types of business. A study of the case reports reveals to the reader the use which may be made of the technique developed in the earlier portion of the book. One is shown not only how weaknesses in the financial structure of a business may be detected, but is shown how to measure reasonably well the degree of dislocation and to seek a remedy for the defect. The matter treated in this volume is of wide applicability and any person who has to do with the interpretation of financial statements should be familiar with it.

ARTHUR W. HANSON

Harvard Graduate School of  
Business Administration

*The Modern Economy in Action.* Caroline F. Ware and Gardiner C. Means. (New York: Harcourt, Brace and Company, 1936. Pp. xi, 244. \$1.60.)

*Modern Economy in Action* represents an attempt to advance a series of questions which need to be considered by economists with reference to our orthodox theory. The writers undertake to prove that the an-

swers to the questions they raise disprove much of accepted economic reasoning.

The main thesis of *Modern Economy in Action* is that industrial conditions have changed to the point where our economic thinking is no longer able to cope with the facts. Particular stress is laid on the rapid growth of technology, with the attendant emphasis on mass-production and large factories. Our present economy is "an engineering economy" rather than a "trading economy" with the emphasis shifted from trading to administration. Likewise we have many industries in which only limited competition exists among a small number of firms in each of such industries.

Modern industry, involving as it does the development of large factories, large corporations, and limited competition, has developed to the point where many prices are said to be inflexible. This matter of inflexible prices is the center of much of the discussion in this volume. Exceptions such as agricultural, textile and petroleum prices are recognized, but the large-scale industries are dominated by administrative policies based on inflexible prices.

In the prior period, which the writers designate as the "old" or "flexible" economy, prices and quantities were controlled through the automatic corrections brought about by competition. In the present system, the presence of inflexible, administered prices prevents the operation of such competition.

In Part II the authors undertake to point out the parts of our economic system which need to be kept in constant adjustment if our economic organization is to function perfectly. Five elements are discussed: the supply of money, the volume of savings and the creation of capital goods, price and production policies of industry, international economic relations, and the provisions of economic security.

Inflexible prices are involved in the consideration of most of these elements. In the case of money, as an example, the existence of inflexible prices necessitates the determination of the "right amount of money." In the "prior" period the amount of money is stated as having had no great influence since all prices were flexible and would increase or decrease approximately the same amount. But when inflexible prices are introduced, the increases and decreases are centered on the flexible prices. Consequently, it is essential to determine by some means the point at which there is just enough money for existing operations.

The matter of international trade is examined from the standpoint of orthodox theory and inflexible prices. With flexible prices and the gold standard, the flow of gold between countries would bring about an automatic correction of prices between the countries concerned. With inflexible prices in existence, any change in prices resulting from the movement of gold would be almost entirely concentrated in the fields in which flexible prices prevail. Consequently, any important movement of gold into or out of a country would seriously impair the economic system by causing abrupt changes in flexible prices.

Some treatment is given to the problems of producing for non-producers, including studies of various ways

of financing social security, of economic planning, and of the role of the Government.

It should be emphasized that *The Modern Economy in Action* is not an attempt to rewrite our economic theory, but points out questions which should be answered and the questions used to modify and strengthen our economic doctrines. The authors seem to have drawn heavily on *Modern Corporations and Private Property* and to some extent on the study of Berle and Pederson in the field of liquidity. Aside from these two sources, much of the material in this volume has been stated many times before. Indeed, much of it is embodied in many of the textbooks used in our colleges today.

Whatever value this volume possesses seems to lie in the lucid statement of some of the weak points in our economic theory. The first part of the work is much more penetrating than the second, but throughout the study the questions raised seem to be of more value than the answers suggested.

F. P. SMITH

*The University of Rochester*

*The Theory of Free Competition.* C. J. Ratzlaff. (Philadelphia: University of Pennsylvania Press, 1936. Pp. xix, 341. \$3.00.)

*The Decline of Competition.* Arthur R. Burns. (New York: McGraw-Hill Book Company, 1936. Pp. xiv, 619. \$5.00.)

Dr. Ratzlaff feels that "... it is necessary to state more clearly the nature, the operation, and the limitations of competition and the competitive order." For this purpose he has selected the period from "... Adam Smith down to the beginning of the present economic depression." The method employed is partly historical and partly analytical, but reliance is chiefly upon the former, especially with the analysis of "... free competition in the important economic writings beginning with Cairnes' work in 1875."

Dr. Ratzlaff stresses the fact that competition should be considered from the point of view of consumption, production, exchange and distribution because it applies to each in different degrees. He considers the essence of economic competition to be the mobility of the factors of production and he contends that "... industrial concentration has aided rather than restricted mobility." Referring to the Classical "School" he calls attention to the common error of assuming that what "... may be said of the views of one, regarding competition, holds in general for all." Of Cairnes he remarks, "Whatever validity there might be, before (his) writing, in the charge that Political Economy and the doctrine of *laissez faire* were one, certainly this ceased with his writings" (p. 127).

Chapter V is devoted to operation, limitations and desirability of competition or substitution, as Marshall sees it, and then passes to Pigou and his argument that state intervention is essential because self-interest (competition) will not tend to equalize marginal social net products of the different industries. As for the Fabian and other socialists, they "... have not seen the es-

sence of economic competition" (p. 232). However, the later socialist thought as well as the earlier agreed upon the necessity of controlling the thing which they did not understand. The author concludes that their programs of control are a repudiation of socialism and in effect a recognition of those steps essential to preservation of "economic competition."

Dr. Ratzlaff's volume, with its excellent bibliography, is useful because it is an effort to ascertain whether there is any meaning to the term "competition" which is sufficiently constant or definite to permit of a synthesis of views of those who favor a competitive society, and his answer is that there is not. There are theories revolving around the concept "competition" but no compact theory because the concept itself is elastic, leading to confusion and contradiction which appears, in the opinion of the author, to be most pronounced in the case of the socialists.

Dr. Burns has written a very different sort of work. He conceives of the era of competitive capitalism as drawing to a close, and he has undertaken to "... throw a fragile bridge across the wide gulf between ... abstractions and the realities which they must finally comprehend." In this attempt he has produced a work of great importance. The element of monopoly has always been present, but it has grown in importance and its elimination by law seems highly improbable. The growth of large firms has so reduced their number that they can easily determine the effect of price policies and output upon the market as a whole and so they find themselves in the position of monopolists, in effect (p. 41). The excellent introductory chapter, "Competition in Transition," is followed by a discussion of the Trade Association, in which it is said that "They were without any long-run vision of the consequences of their policies and contributed little to the adjustment of industrial policies to the changing techniques of production and selling."

The policies referred to are then carefully analyzed in turn. Of these, "Price Leadership" as practiced in various industries comes first. It has not been effectual in stabilizing industry, since the prices thus fixed have encouraged the entrance of new capital into the industries involved. The author is therefore inclined to think prices leadership transitional (p. 108). The analysis passes to "Sharing the Market," a subject of significance because "Price competition can no longer determine the distribution of business between firms ..." and a quota is, therefore, usually set for each. "The Stabilization of Individual Prices" is the subject of Chapter V. Dr. Burns observes that price stabilization has become effective over an increasingly wide industrial field, a fact which is not at all pleasing when it is realized that "The elimination of the less efficient is retarded by price stabilization in a number of ways ..." (p. 268). Moreover, the author doubts whether "... over a long period of time a stable price policy is more profitable than one of adjusting prices to conditions of demand and supply."

"Price Discrimination" is analyzed in the same thoroughgoing manner with continued reliance upon the actual practices. Outstanding in these two chapters

is the excellent treatment of "Basing-point System." The chapter on "Non-price Competition" reaches the conclusion that it is beginning to decline in importance. As for "The Integration of Industrial Operations," it is in a large measure "... explicable in terms of considerations that would be absent from a purely competitive world." Sixty pages are devoted to "Industrial Policies under the N.R.A.," and the result is a brief analysis of high quality with many penetrating statements. The two final chapters relate to "The Problem of Social Control," first as to objectives, and second as to means. Control by judicial officers is rejected because "... they lack training necessary to handle problems of economic control." But, there is no single type of training which alone can be regarded as a prerequisite to control agencies. In any event, there must be control and that control must come from the state, for competition can only be preserved by law, and that form of state intervention is far less undesirable than intervention in the exercise of "... the already concentrated economic authority." Such is the conclusion of the best analysis that has been made of industrial price and production policies "... from the years preceding the Sherman Anti-Trust Act of 1890 to the end of the effective life of the National Industrial Recovery Act of 1933."

The volume is fully documented, indeed, numerous supporting passages are partly or fully quoted, and the author has exhaustively studied treatises, public documents, court papers, and legislation and administrative orders. Apparently nothing has been overlooked. Thus it becomes possible to say that this is an outstanding work which makes a demand upon every student of the present economic order if he is to be considered informed.

E. A. KINCAID

University of Virginia

*The Downfall of the Gold Standard.* Gustav Cassel. (New York: Oxford University Press, 1936. Pp. viii, 262. \$2.25.)

*Is There Enough Gold?* Charles O. Hardy. (Washington, D.C.: The Brookings Institution, 1936. Pp. x, 212. \$1.50.)

Dr. Cassel feels that we are passing through a transformation that involves nothing less than the final de-thronement of gold as the basis of the world's monetary system. The circumstances involved are traced to original documents and the personal contacts of the author with the flow of events. For many years he struggled for the restoration of an international gold standard, but he now feels that "... a new attempt at restoration would be hopeless." Indeed, the very idea of a return to that system "... must be rejected as extremely hazardous; and we shall henceforth have to devote all our efforts to building up a new monetary system, entirely independent of gold."

Of "The Gold Standard in the light of pre-war experience" he contends that such success as it had was due to the basic position that the pound sterling held in the system. Even before the war, the "... inalien-

able right of the individual to convert his currency into gold for free use," had ceased to be recognized as the fundamental principle of the gold standard. As for the post-war period. Dr. Cassel holds that "... Mr. Churchill was quite right in deciding to return to the gold standard at that particular time (1925)." What made the whole situation intolerable was the tremendous rise in the value of gold after that time. But the failure of England to remain on a gold basis was due to defects of the standard rather than premature return to it and failure to accept this view has defeated sound thinking. As for the difficulties, reference is made to the scarcity that resulted from insufficient gold production (p. 49) and to the "... very one-sided distribution of the world's gold reserves. . . ." These facts contributed to deflation of prices and that, in turn, brought on the American crisis of 1929 and "... the most violent and widespread depression in the world's economic history. . . ." (p. 62). A contributing element was the maintenance of gold reserves rather than the redeemability that these reserves were to guarantee, and "The lesson of all this is that the international gold-standard system is a very dangerous mechanism." Accordingly, it is unfortunate that, due chiefly to the influence of the Bank of England, the Exchange Equalization Fund has been used to keep sterling tied to gold to such an extent "... as to prevent British monetary policy from attaining, to any appreciable extent, its avowed objective of raising sterling prices" (p. 94).

"Postponement of monetary reform" resulted from the refusal of politicians to accept the inconvenient truths so clearly brought out by Keynes and other economists until at last the collapse came. It was then that Mr. Hoover sought to check the trend by his "prosperity propaganda," but he failed because he could not grasp "... the monetary nature of the depression. . . ." Dr. Cassel comments that "... no nation has been more heavily penalized for having followed incompetent counsellors. . . ." (p. 113). The consequence was abandonment of the gold standard, "... a deliberate step taken in order to stop deflation. . . ." and he finds it curious to observe how long it took the world to recognize the true implications of the act, namely, the intention to set up some other standard (p. 132). It was, then, no wonder when the President refused to adhere to the proposal of the London Conference to stabilize currencies in terms of gold, and he "... merits unreserved praise for the directness of his comments on this resolution" (p. 151), for the President "... had seen the main lines of the problem far more distinctly than the majority of the delegates. . . ." But Dr. Cassel seems unable to speak so favorably of the Administration's silver policy, for he remarks that "It was sheer madness to try to help them (silver-using nations) by raising the price of silver in terms of gold. . . ." However, this little weakness of policy is soon forgotten in the satisfaction that comes from the Gold Reserve Act of 1934, for it seems to justify the observation that "... there can be no talk of the United States having returned to gold as a definite standard of value" (p. 184).

The devaluation of the dollar was most injurious to

countries adhering to the gold standard, since they "... had to go through a further process of deflation ..." which would tend to raise the value of gold in gold bloc countries while it was the policy of other countries to cheapen gold. However, England would have accomplished more "... if the price-raising policy had received the unreserved support of the Bank of England" (p. 205). The Sterling Bloc has stabilized prices under a paper-standard system, but "... the net result of all government interference in the economic sphere is negative." Yet, Dr. Cassel seems to be pleading the case in behalf of managed currency. At any rate, the United States should continue its intervention to the end that prices be raised still further, in keeping with the aim of President Roosevelt (p. 222), even though there is danger that the movement will be carried beyond the point of "sound recovery" to the point of "an unbalanced boom." He finds that "... the situation at the end of 1935 offers a singularly clear demonstration of the practical necessity for making monetary policy entirely independent of gold reserves." And this is because: (a) There is not the "... slightest hope for such a redistribution of gold reserves as the (orthodox gold-standard) theory requires ..." (b) Moreover, there is little prospect of adoption of a policy of adjusting credit to gold reserves. (c) Besides, the gold standard has lost all those qualities which make its restoration desirable or possible. It is therefore essential to set up an international monetary system which will operate as the Sterling Bloc has operated its system. In any event, the downfall of the gold standard "... now stands out as the most prominent and definite feature of the economic history of our generation."

Dr. Cassel's most interesting funeral oration over the gold standard comes as rather a shock to those who are familiar with his early writings, not only because of the reversal of his position, but also because the economic analysis employed does not measure up to previous standards set by him. This becomes more apparent when one turns to Dr. Hardy's "Is There Enough Gold?" for this little volume denies some of the postulates upon which Dr. Cassel bases his case. For one thing, Dr. Hardy holds that the results of Cassel's work on the quantitative relationship between the gold supply and the price level "... are not acceptable, ..." Dr. Hardy finds "... 1.5% per annum as our best approximation of the amount of new monetary metal required under nineteenth century conditions to maintain stable prices ..." (p. 39). However, two per cent is adopted as a reasonable compromise, and Dr. Cassel's three per cent is rejected as "... much too high ..."

In the next place, Dr. Hardy finds that "... there was no sound reason in 1929 for anticipating any decline of world production in the decade of the thirties, assuming a continuation of the 1929 price level" (p. 61). Working his way step by step, Dr. Hardy next concludes that "... the declining prices of 1925-1929 and the collapse of 1929-31 are not to be explained in terms of an inadequate gold supply" (p. 83). The real menace was in the steady mounting of the reserve requirements, and for that reason he refers to the real menace in an unmanaged gold standard. It is admitted that there is

a bad distribution, but this in itself is not fatal to a restoration of the gold standard (managed), assuming that it cannot be redistributed in a rational way. Rather, it is the danger that credit expansion will take place on the basis of accumulated and growing reserves. Conditions would be vastly improved if "... the bulk of the excess of gold ... above legal requirements (were now) being held in commercial portfolios and not in the reserve accounts" (p. 119). Meanwhile, no possible gold supply will be adequate while international transfers of funds continue on the present scale.

It is apparent, therefore, that Dr. Cassel's report of the death of the gold-standard seems to be exaggerated and premature. One can admit the limitations of that standard without jumping to another, the limitations of which are unknown. The remainder of Dr. Hardy's study is devoted to the Warren-Pearson theory of gold prices. It is not too much to say that he has completely invalidated that theory, in so far as it relies upon their data. In the first place, their method was defective. Thus, if the price collapse of 1929-33 was caused by the demand for gold following upon the adoption of the gold standard, "... why did it never register itself as a factor worthy of the authors' attention in their study of the 75-year period before the war?" (p. 150). In the next place, their explanation of the post-war history of prices "... does not square with the history of the stabilization process." Dr. Hardy observes that Warren and Pearson have overlooked "... the rise of central banking systems which cut the connection between gold ... and money or bank deposits ..."

This small volume by Dr. Hardy makes it impossible to accept the thesis of Dr. Cassel as to the dark future of the gold standard, and at the same time it undermines the validity of the Warren-Pearson explanation of the great depression. There is no telling what damage the book may have done to other writings. Reference should be made to "Appendix A," *The Myth of 1849*, by Rufus S. Tucker, in which data are submitted to show that there was no general upward trend of commodity prices in the 24 years following the discovery of gold in California.

E. A. KINCAID

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*Economic Thought and Its Institutional Background*, H. W. Peck. (New York: Farrar & Rinehart, 1935. Pp. 379.)

This excellent study covers almost the entire range of economic thought from the Canonists to the Collectivists, and at the start the author explains that his "... method of approach ... will be to correlate economic theory and industrial history." with the purpose of showing how various types of economic thought came into existence. In addition, the author proposes to "... reorient economic history upon the law of supply and demand, and the law of the proportion of factors." As for the institutional approach, it is explained that "... the owners or representatives of the scarcer or relative backward factor (among those upon which prosperity is conditioned) try to institutionalize and perpetuate the advantage due to historic scarcity of

their factor." Thus it came about that foreign trade did more than any other force to break down the medieval social order. The new factor, regional or foreign trade, became the limiting factor in the new economic system.

In the chapter on "Mercantilism," the theory is advanced "... that while nationalism as a conscious government policy meant the regulation and hence the restriction of foreign trade, it achieved incidentally the liberation of domestic trade." In the discussion of "Physiocracy," Dr. Peck maintains that agriculture became the limiting situation. Here also is an interesting discussion of the rise of the concept of the economic man, and it is the author's conclusion that the concept was a socially useful fiction.

Passing to "Early Classicism," the author remarks that the "... theorizing of the Industrial Revolution gives us English classical economics," and he then passes to an analysis from which emerges the conclusion that "... the assumptions of early classical economics corresponded closely enough to the main features of the life of the time, so that the theory served to explain in a great measure the actual experiences of men and to furnish a useful basis for a public policy." There follows a chapter on "Later Classicism" in which the concept of productive labour is analyzed, with the observation that "Productive labour was that kind which is employed in creating capital, because at that time capital was the expansible and relatively the backward factor." He also remarks that "... the generalizations of Ricardo were based on peculiar social, economic, and legal conditions", and he concludes that Ricardo "... was generalizing from conditions that prevailed in England for only a few years" (p. 110). Moreover, his "... generalizations in the field of distribution were too arbitrarily simplified to be permanently valid." But that is not all, for it is said that the "... method of Ricardo appears ... as a rather elaborate relationization of the interest of the class to which Ricardo himself belonged." But, most significant of all, is the author's conviction that "... a work like Malthus' *Principles of Political Economy* would be more useful at the present time than Ricardo's *Principles of Political Economy and Taxation*." Finally, it is observed that "... a good many of the so-called classical laws are simply social class rationalizations formulated as analogies to physics or astronomy" (p. 155), whereby "... classical economics, which began as a middle-class reaction against a landed aristocracy, developed eventually into a theoretic justification of a capitalistic aristocracy." With the findings of this brilliant analysis of Classicism one must for the most part agree, with certain reservations.

The discussion then passes to "Marginism and Pecuniary Analysis," concerning which Dr. Peck maintains that the "... chief point of departure from classicism was the attempt ... to explain exchange value by states of feeling or consciousness rather than from the point of view of objective physical commodities." He clearly brings out the contributions of the marginists but holds that "... it is apparent that the marginist analysis has been rendered obsolete by the latest development in psychology." One of the best chapters of the volume is that on "The Newer Capitalism," the

chief characteristic of which "... is the recognition that under modern conditions there is a new combination of factors." Among the latter invention is given a prominent part. The dilemma of The Newer Capitalism is particularly well discussed and quite helpful in understanding the recent economic disturbance in this country (p. 250). The part played by the elements of rigidity in the economic system is by no means overlooked.

The chapter on "Economic Theory and Economic History" is devoted to a review of the history of economic thought "... in order to secure materials for a reconstructive synthesis of economic theories." In this connection, Dr. Peck remarks that "... realistic description and history record the changes which represent the multitudinous illustrations of the law of proportions." A short chapter is devoted to "Welfare Economics," which is characterized as economic theory in the light of ultimate values. Much more space is allotted to "Institutional Economics" and Dr. Peck refers to its "... apparatus of ways and means (as) a legacy of habits from the past. These widespread habits of thought and action are institutions" (p. 302). Institutionalism is "... an understanding of the mechanism of how social phenomena came to be, an explanation of how we got that way. ... Institutionalism is not a method valuation; it is a tool, a mechanism of social process. ... the economic theory which holds that economic life is determined not by economic laws but by economic institutions." The final chapter considers "Collectivism" in a brief but effective analysis in which it is said that "Communism assumes that the mass of men are 100% or nearly 100% plastic." Plasticity becomes a vital subject when industrialization brings about friction with other social institutions. The author concludes that collectivism would be more democratic, more equalitarian than the partial individualism of America and most of Europe. But its contribution to welfare would depend upon "... the specific character of the real income secured by wage payments."

Dr. Peck has written an interesting, scholarly, and penetrating analysis of the influence of "institutions" upon economic thought. Moreover, it is highly original, although it is not wholly unlike Dr. Commons, "Institutional Economics."<sup>1</sup> Most economists will find the book stimulating and useful, because it deals with economic thought from a perspective that is gaining an increasing acceptance. One must admit the importance of the approach and the effectiveness of treatment employed by the writer, but it does not follow that the method is exclusive or even sufficient. However, it constitutes an important element in the explanation of economic thought.

E. A. KINCAID

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*Introduction to Governmental Accounting*. Second Edition. Lloyd Morey. (New York: John Wiley & Sons, 1936. Pp. xvi, 318. \$3.50.)

The new text on governmental accounting by Lloyd Morey is an admirable presentation of the principle of

<sup>1</sup> See the ACCOUNTING REVIEW, December, 1935, pp. 421-22.

fund accounting as applied to governmental fiscal affairs.

However, in my opinion, while it might be readily adapted to the larger municipalities where the personnel is adequate and understands accounting terminology, I do not believe much of it would be understood by the personnel of the average sized municipality, particularly that section relating to the budgetary accounts, setting up encumbrances against appropriations for orders and contracts placed, and reversed when vouchers are audited. The setting up of these encumbrances, while essential in arriving at unencumbered balances of appropriations would entail too much effort and keeping of records. The clerical force would have to be increased.

While I do not hold, as many accountants do, that the advantages derived from charging orders instead of payments are not worth the effort, still I do believe the expenditures may be properly controlled without all these entries being made on the financial records. A properly constructed order system should yield all the information needed to control expenditures, by issuing orders in triplicate form, two to vendors and one retained by the order clerk, the latter keeping a record of all appropriations and charging each appropriation with the order. As invoices are received, they are charged against the order. All open orders thus are easily determined. A book of three money columns and adequate space at the left for explanations would suffice. The object of the expenditure would show above together with the amount of the appropriation. The first money column should show the amount of the order, the second column for vouchers received, and the third for unencumbered balances.

Any system of accounting for a municipality must be designed from a reporting standpoint. What forms and reports does the state require annually? The financial reports prepared from the records should serve not only for the guidance of municipal officers, but also should facilitate the preparation of the annual state reports.

In my opinion, it would be difficult in New York State to prepare the report the state requires from the nine separate funds constituting the municipal balance sheet disclosed by the text. In New York State, for example, we confine the activities of a municipality into six separate funds. The bond fund is incorporated with the so-called fixed assets and liabilities. We do not use the so-called working capital fund, but incorporate this fund in the current or budgetary section of the accounts.

The section designated as fixed assets and liabilities, which we often call the capital section or capital fund, in my opinion, should be included with the bond fund section, excepting that in place of keeping an account for property and charging that account when work is completed on a capital improvement, I would charge an account called "Deferred Charges to Future Taxation," and merely keep an underlying record of all fixed property values belonging to the community. The paragraph on depreciation states that when the property is disposed of the account is credited with the cost of the property, and that the interest in such an account merely is "What did it cost the government?"; and also since no replacement fund is created for reserves for

depreciation there is no occasion to provide for depreciation as an expense. This latter view is perfectly sound. Then why keep accumulating a property account which merely shows cost when gradually it is becoming exhausted in service. The bonded indebtedness which financed the operations leading to the acquisition of fixed assets is secured not by a lien against these assets, since these belong to the community in perpetuity, but are secured by a pledge against future tax collections. The text also mentions the advantage of separating the fixed assets from bond liabilities for the above reasons. The only point, then, seems to be the propriety of keeping an account for fixed assets, which I would charge to a special account more clearly reflecting its nature. As the bonds are liquidated through budget appropriations and sinking fund accumulations, a collateral entry in the capital section should be made charging the bonded indebtedness account and crediting the special account called "Deferred Charges to Future Taxation." Gradually, this latter account is being reduced, at the same time the liability for the bonds is being reduced.

This latest contribution, however, on municipal accounting by Mr. Morey, is the most comprehensive text we have had, and should prove an invaluable aid to municipal officials, teachers and students of this subject.

WILLIAM WIDER

New York University

*Introduction to Principles of Accounting.* Revised Edition. H. A. Finney. (New York: Prentice-Hall, Inc., 1936. Pp. xv, 629. School \$4.00; Business \$5.00.)

Texts on the elementary phases of accounting, despite their profusion, always hold an interest to the teacher of the subject. This interest is increased when it is known that the elementary text comes from the pen of a well-known writer. This is the case with the book under review. Widely accepted as released in its first form (seven printings having been sold of the first edition in four years) it now appears in its revised form.

The approach to the elementary subject matter as developed by Professor Finney is a departure from the ordinary. The author believes in an immediate introduction of corporation accounting and, to quote from the preface, argues "While the approach through the individual proprietorship is traditional, there seem to be several reasons for beginning with the corporation.

"In the first place, students should obtain at the very beginning of the course, a clear concept of net worth, or capital. When the course begins with the individual proprietorship, a needless source of confusion is introduced, as students find it difficult to distinguish between the capital of the business and the aggregate net worth of the proprietor.

"In the second place, it is believed that the changes in net worth resulting from profits, expenses, and distributions can be explained to a beginner more easily and clearly by showing their effect upon the surplus of a corporation than by showing their effect upon the capital and drawing accounts of a proprietor.

"In the third place, the accounting principles applicable to extraneous profits and adjustments of prior year's earnings involve a distinction between profit and loss and surplus. . . ."

The arguments as given have merit and the corporation approach seems to be finding acceptance.

This text covers completely all of the material usually included in an elementary text. In addition, it contains material normally associated with the second-year's work such as the chapters dealing with the valuation of cash, receivables, inventories, and fixed assets and those dealing with bonds, sinking funds, and sinking fund reserves, consignments, and the factory and private ledgers. This overlap of material may be justified, however, as being included for use in the great number of schools where only the first course in accounting is given and where it is desired to make that course cover a greater range of subject matter.

The text is amply illustrated and clearly written and contains adequate question, problem, and practice set material. In development, it is characterized by the same thoroughness that has prevailed in the author's earlier works.

A note of minor criticism, at this point, should not detract from the favorableness of the present review. However, to this reviewer it seems strange to find, in a text on accounting published at so recent a date, that prepaid expenses are still classified as deferred charges.

This text is well worthy of the attention of students and teachers of accounting.

JACOB B. TAYLOR

Ohio State University

*Mathematics of Finance.* Thomas M. Simpson, Zareh M. Pirenian, Bolling H. Crenshaw. (New York: Prentice-Hall, Inc., 1936. Pp. xiii, 469. \$3.75.)

The present work like others published within the last twelve-month period covers what by now seems more or less familiar ground. In Part I is to be found the usual review of algebra, to make up for the deficient training in mathematics given to the present generation of college students during their secondary school days. Every teacher of college algebra has had this same sense of futility and wasted effort because of the lack of understanding on the part of the student of subject matter supposedly covered in our high schools, but which must be gone over once more at college. However, the authors have done a good job and the introductory part is not unduly expanded.

Among the chapters in Part I, those particularly welcome are the chapters on Percentages, Simple Interest and Discount. A chapter has been added on Statistics, showing the various types of averages, curves, measures of dispersion, and even simple correlation. Index numbers seem to have been omitted and also analysis of time series; but even so, to compress the subject into a single chapter of about 20 pages required considerable courage, and the authors are in no way to be blamed for its possible shortcomings. It is hoped that in some future revision this topic may be expanded further, and the basis laid for a true development of the mathematics of statistics.

Part II deals with compound interest, annuities, and life insurance. Chapter XI introducing compound interest and discount, is particularly well developed.

Chapters XII and XIII deal with annuities, but not until Chapter XVII is the general case developed, and then in somewhat too brief a compass.

The tables accompanying the text are good. Beginning with a six point log table, through the eight place compound interest and annuity tables, the student is made to feel that he is using a tool of great accuracy, and that confidence may be placed in the answers obtained to given problems.

Pedagogically, the book is sound. Many new problems have been introduced and these are always welcome. The necessity of checking answers is emphasized. The language is adapted to the training expected of the students taking the course. Technical terms are avoided as far as possible. As new terms arise, they are defined clearly. At the end of each chapter, a miscellaneous exercise is inserted dealing with the principles and methods in the chapter. At the middle and at the end of the book, a general review exercise is placed. Together these exercises contain 295 problems covering all the material in the text.

THEODORE LANG

New York University

*The Monetary Problem: Gold and Silver.* Ralph Robey, Editor. (New York: Columbia University Press. Pp. xxviii, 369. \$3.50.)

The editor of this volume, Dr. Robey, makes a concise and clear statement of the circumstances leading to the appointment of the Commission. It is interesting to note that the personnel of the Commission included one avowed economist, several high government officials, one scientist, Sir John Lubbock, several bankers and bimetalists. Among those who gave testimony were Mr. R. H. Inglis Palgrave, Mr. J. Shield Nicholson, and Sir Robert Giffin. Dr. Robey points out that the United States, in recent years, has pursued a monetary policy which will effect world economy for years to come. For these effects we should prepare ourselves and to that end "... no single discussion in the field of economics is more worthy of study than ..." this Report.

With this view of the editor one can readily agree, if for no other reason than that the Report makes obvious the great progress that has been made in monetary thought since the Report was first published. Indeed, considering the undeveloped state of monetary economics at the time, the Report is rather a remarkable document. It should be added that the knowledge of bimetalism at that time compares favorably to what is known about the subject at present, but as much cannot be said of credit and its control. One of the causes leading to the appointment of the Commission was the collapse of the Latin Monetary Union and referring to that Union, the Commission observed that "... so long as it was in force ... it kept the market price of silver approximately steady at the ratio fixed by law. ..." Part I reached the conclusion that the instability of the price of silver was due to a combination of causes. Beyond that point the Commission was unable to agree, hence separate reports were submitted

with reference to "... what extent the fall in the gold price of silver has taken the form of an appreciation of gold or a depreciation of silver ..." and the remaining problems submitted to it.

Part II contains the report of the six members (out of twelve)<sup>1</sup> who took the view that "... the greater part of the fall (in the gold value of silver) has resulted from causes touching the commodities, rather than from causes specially affecting gold;..." These same members also concluded that the fall was mainly due to circumstances independent of changes in the production of, or the demand for, the precious metals or the altered relation of silver to gold (p. 192). They also reported adversely to the adoption of bimetalism.

Part III contains the report of the other six members. They ascribed the greater part of the fall in the gold value of silver to monetary causes (p. 220). It is a more able and convincing document than the "majority" report, from the context of which one can conclude that its signers preferred the increased commercial independence that Great Britain would realize from a gold standard, since a gold standard would also be a sterling standard.

Not the least valuable part of the volume is the excellent note by Sir Louis Mallet, in which he contends that "... there has been an appreciation of gold and a depreciation of silver in unascertainable proportions" (p. 259) and the remedy for conditions is to be found in a return to bimetalism. The note of Mr. Barbour also adds much to the value of the report. While the majority report (Part I) is a skillful summary of the evidence, the remaining reports are more effectively presented. The center of conflict among them is to be found in the weight to be given to the falling costs of production of goods and the increased volume of production, on the one hand, and the appreciation of gold on the other. The "majority" appear to give much weight to the former while the minority stress the latter. Kemmerer analyzes the same problem and concludes that for the period, 1873-1893, "... the decline in the gold price of silver was chiefly an expression of an appreciation of gold, not of a depreciation of silver."<sup>2</sup>

Dr. Robey has performed a valuable service in making these reports available in such an attractive form, particularly at a time when bimetallic sentiment appears to be renaissance. Fortunately, all of the issues involved were fought out years ago and facts are clearly set forth in this volume.

E. A. KINCAID

University of Virginia

*Money and Banking.* George W. Dowrie. (New York: John Wiley & Sons, 1936. Pp. viii, 512. \$3.25.)

Dr. Dowrie intends this volume to be "... an introduction to the study of money and banking," and he has realized his intention, for it is exactly that, especially the first 112 pages that are devoted to money.

<sup>1</sup> All parentheses are mine.

<sup>2</sup> *Money*, p. 364. See *ACCOUNTING REVIEW* for June 1936, pp. 201-2.

The treatment accorded this subject has the merit of being up to date when the book was published, but shortly thereafter, France altered the government of the Bank of France and then with other countries in the "Gold Bloc" abandoned that metal as a standard, thereby subjecting this new text to the fate of most others on the subject. The treatment of money affords barely more than an excellent outline which should be filled out with assignments to other treatises and by lectures. Indeed, some such supplementing is essential, if the text is used in the larger institutions. As it stands, it will make a strong appeal to those instructors who find it impossible to specialize in the subject. All of this conforms to the intentions of the author. Thus, he says "... we shall confine our approach to the equation of exchange with the hope that readers will be sufficiently interested to read the writings of Hawtrey, Robertson, Pigou, Keynes, and others who depart from the approach employed here" (p. 69). However, such brevity seems quite unnecessary when it is realized that each chapter concludes with a summary so full that it is needlessly repetitious.

Chapters VIII to XIX, inclusive, relate to commercial and central banking. The treatment includes the effects of legislation since 1933 in a more orderly and simple manner than is true of most texts, and here and there one finds a passage of unusual interest, such as that on page 118, to wit, "Our laws should provide that the capital stock and surplus should never be less than some fixed percentage of the bank deposit liabilities, say 15 to 20%." If the percentages given are merely illustrative, they are acceptable, but even so it is doubtful whether such legislation should apply to all banks. It is easier to agree with the statement that "... we permit a bank to scramble its demand and savings deposits together." But one must regret the failure of Dr. Dowrie to seize his opportunity to bring out the defects of the correspondent bank system as developed in this country. In addition, is it possible to approve of the use of the term "profits" as applied to the proceeds of devaluation? It is unfortunate that the author, like most economists, includes net worth items under "Other Liabilities," an awkward and obsolete arrangement which only makes analysis of statements more difficult.

Dr. Lowrie feels that the number of commercial banks should be limited to the amount of legitimate commercial banking that is available. The type of banking that has evolved since the World War does not appeal to him. Indeed, the record of the years from 1920 to 1933 shows both state and national banks to be deficient with respect to (a) low minimum capital requirements, (b) freedom to establish branches, and (c) lack of authority to compel erring bankers to correct bad situations before it is too late. Dr. Dowrie is progressive in his views and fully conversant with the lessons of these years. He would have the minimum capital of banks fixed at \$100,000. As for branch banking, it will spread because of the profits to be gained thereby (p. 205). Departmentalized banking could be improved by preventing one department from exploiting another.

But what is really needed is sound banking tradition, the lack of which can never be made up by legislation and regulation (p. 214).

The chapters on central banks contribute to the value of the text, particularly certain passages relating to the Federal reserve system. Of the latter, he remarks that "... the whole plan of membership is wrong," since the stock of the reserve banks should be held by the public, and their services should be available to all banks (p. 279). Again, speaking of liberalized secured loans, it is said that "Only a strict interpretation by the Board beyond anything one has any reason to expect will preserve the assets of the Reserve system from marked deterioration," even though the Board and the reserve banks have the power to "... maintain sound credit conditions" (p. 317).

The chapters following these on central banks consider foreign exchange, international financial relationships, and non-commercial banking. In connection with the latter Dr. Dowrie observes that "It will be interesting to see how efficient a collector a government enterprise (such as Home Owners' Loan Corporation) dares to be where a million householders are concerned" (p. 287). As for the remaining Federal credit enterprises, they have not yet justified their existence. To the reviewer this seems rather strong, since their purpose was the restoration of consumer purchasing power, and to that end they have contributed. The same may be said of low interest rates to farmers, even though they may eventually tend to overborrowing (p. 423). More acceptable are the vigorous criticisms of the systems of examining and reporting on banks. "Too often because of influence which he had not the courage to withstand, or a tendency to temporize, he (the superintendent) has permitted the situation to get completely out of control" (p. 443). Again, Dr. Dowrie remarks, "With few exceptions both the position of superintendent and that of examiner are still in politics."

The author feels that the Federal insurance of bank deposits is not a step in the right direction, but he does approve of Federal intervention to check the depression of 1930-35, since it "... was too severe and the danger of complete economic upheaval too great to allow nature to bring about recovery unassisted," even though (p. 476) "... monetary instruments to recovery have made little contribution to the progress that has been made out of the depression ...." But he submits no data in support of this statement. In the final chapter there are a number of striking remarks, including the statement that the "Abolition of state-chartered commercial banks would enable the federal government ..." to bring about certain definite improvements, including the normal growth of branch banking. Here also he reverts for the third or fourth time to importance of a suitable ratio of capital and surplus to deposits. This time he favors a ratio of \$1 to \$6 and considers such a ratio superior to the requirement for surplus equal to capital paid in. In each instance he appears to overlook the fact that the suitability of any ratio depends upon liquidity of assets. Here also he makes it clear that he favors both unit and branch banking (p. 502), and it would seem that he favors a

central bank with twelve branches, in contrast to our present system.

The tone of this text is liberal and progressive, and at the same time it is sound. Even so, the text would have been far stronger if the theoretical connection between money and banking on the one hand and between commercial and non-commercial banking on the other had been brought out. A thread of connecting theory running through the entire volume would have added to its effectiveness as a treatise and as a text. Even so, the book will make a wide appeal because of the clearness of its style and the simple lines along which the subject is presented. It is a good text with which to lay the foundation for a course of reading and lectures which will fully develop the subject.

E. A. KINCAID

*University of Virginia*

*Operating Results of Department Store Chains and Department Store Ownership Groups, 1929, 1931-1934.* Stanley F. Teele, (Boston: Harvard University Bureau of Business Research, 1936. Pp. iv, 52. \$1.00.)

For those not immediately interested in retailing, there may be some confusion between department store chains and department store ownership groups. The distinction is not absolute and probably can best be defined by example. The department chains are, in many respects, exalted variety chains and include such chains as the J. C. Penney Company and the retail stores of the large mail order houses. Most of the merchandise for these stores is purchased at the central office. Sales promotions, advertising, and display plans are also provided by the same office. The primary function of the retail store is to sell merchandise. As a result, from 80% to 90% of the employees within the store will be active in selling merchandise at least part time. Three or four employees in the office will handle the clerical and cashier work of a store selling from \$200,000 to \$300,000 annually. In the usual department store of the same size, the number of non-selling employees will be from two to four times as great. It is little wonder, then, that department store chains operate at relatively low cost. Total expenses from 1931 to 1934 including interest on investment range from a high of 27.58% in 1932 to a low of 23.65% in 1934. The largest single item of expense during this period is salaries and wages which amounted to approximately 12% of sales during the period.

The department store ownership groups, on the other hand, operate in many respects like an independent store. In fact, few of the customers of Lord and Taylor of New York, and a member of the Associated Dry Goods Group, or of the Jordan Marsh Company of the Allied Stores Corporation, think of them as semi-chain stores. These stores both in respect to operation and in respect to customer service are distinctly similar to independent stores. In contrast with the low operating expense of department store chains, the ownership groups have a total expense, including interest, that ranges from 35.3% in 1930 to 40.4% in 1932. The largest single item of expense, salaries, and wages hovers around 18%.

There is also a considerable variation in gross margin in the two types of institutions. The chains had a gross margin from year to year of 25% to 30%. The gross margin of the ownership groups, on the other hand, ranges from 34.5% to 37%. The net results are that while the chains were highly profitable throughout most of the period, the ownership groups were no more successful than independent department stores and with interest charged on invested capital showed a net loss throughout the entire period.

By far the most pertinent section of the Bulletin is entitled "Operating Expense of Department Store Chains and Department Store Ownership Groups Compared." In this section expenses of the chains and ownership groups are compared item by item and a searching analysis is made in seeking the causes of the wide differences shown in the expense figures.

The author is very cautious in reaching any conclusions. After a brilliant analysis into the causes of differences between chains and ownership groups he summarizes as follows:

This comparison between the expenses of department store chains and ownership groups has not been made with the thought that it points conclusively toward a course of action for the managements of the latter firms. But the wide disparity between the total operating expense of the chains and the ownership groups cannot but raise the query as to whether the recognized differences in the character of the business done and in the conditions of operation require the perpetuation of so great a difference in operating costs. Particularly in the area of personnel costs there seem to be at least some indications that the spread might be reduced by the ownership groups. Continued experimentation in the direction of greater centralization of buying and control may reveal the means by which this reduction may be accomplished.

To the reviewer this bulletin substantiates the conclusion of the Harvard Research Group that more profitable operation in the department store field will largely come about through a decrease in expense. The department store chains and other groups of retailers with relatively low operating costs and low gross margins limit the gross margin of the ownership groups and independent department stores. More profitable operation by the latter stores can only be secured through keeping total expense below a gross margin which is indirectly determined by competing stores with low costs of operation.

EDGAR H. GAULT

*University of Michigan*

*School of Business Administration*

*Alexander Federal Tax Course and Guide—1937.* (New York: The Alexander Publishing Company, Inc., 1936, \$7.50.)

The text material of the Alexander Federal Tax Course consists of twenty-three chapters, which may be summarized as follows:

#### Chapter

- 1 Historical
- 2 Rates, Credits and Computation of Individual Income Taxes
- 3 Excluded Income
- 4-5-6-7 Gross Income
- 8-9 Deductions
- 10 Corporations
- 11 Partnerships and Trusts
- 12 Inventories
- 13 Tax Credits and the Tax Incidence in Special Cases
- 14-15 Legal Procedure
- 16-17 Outline of Changes Made in 1935 and 1936 Acts and Rulings Relative thereto
- 18-19 Tax Accounting Methods
- 20 Tax Saving Methods
- 21-22-23 Capital Stock, Excess Profits Tax, Manufacturers' Excise Taxes, and Taxes Imposed under the Social Security Act

Each chapter is followed by a series of questions on the material covered in the chapter and by research references to sections of the law, articles of regulations, court decisions and rulings.

In the second section of the course model returns for individuals, corporations, partnerships and fiduciaries are to be inserted when released by the Department.

The third section includes two hundred practical problems, which are correlated with the chapters and paragraphs of the text.

The next section consists of the text of the income, estate, gift, and stamp taxes which are now in effect.

In the last section of the course the following are printed in full: Regulations 86 relating to the 1934 Act; T.D. 4674 relating to surtax on undistributed profits of corporations, credits to corporations and distributions by corporations; T.D. 4677 relating to non-recognition of gain or loss upon receipt by corporation of property, and basis of property distributed in complete liquidation of another corporation; T.D. 4678 relating to the taxation of mutual investment companies under the revenue act of 1936; Regulations 95 relating to the tax on unjust enrichment.

The three hundred and thirty-nine pages of text material contained in the twenty-three chapters of this course are a masterly condensation of present federal taxes, regulations, rulings and decisions. The material is presented in a logical manner and its study is aided by the questions, problems and research references for each chapter. The book should be valuable not only as a text for a course in the principles of federal taxation but also as a reference for the solution of tax questions.

JAMES V. TONER

*Boston University*

*College of Business Administration*

## UNIVERSITY NOTES

### UNIVERSITY OF CALIFORNIA AT LOS ANGELES

A College of Business Administration has been established at the University of California at Los Angeles and this year is offering for the first time to students interested in business a four year curriculum leading to the degree Bachelor of Science. Professor Howard S. Noble has been appointed Dean of the College. Five fields of study are being offered: Accounting, Banking and Finance, Management and Industry, Marketing, and General Business.

The staff of the College will include the following new members: Ralph Cassady, assistant professor of marketing, who comes from the University of Minnesota; Arnold C. Eger, lecturer in business law; Perry Mason, lecturer in Accounting, who comes from Antioch College; William F. Brown, instructor in marketing; John C. Glendenin, instructor in banking and finance, who comes from Washington State College; Harry Simons, associate in accounting; John H. Cory, Elston K. Herrald, Conrad C. Jamison, and Ronald C. Roeschlaub, assistants.

### UNIVERSITY OF COLORADO

Assistant Professor Kendrick will be on leave of absence during the winter quarter of this year to do research work in the field of budgets and accounting control at Stanford University.

Ronald Rucker, from the University of Illinois, and Russell Knapp from the University of Chicago, are additions to the staff as instructors in accounting.

### UNIVERSITY OF DENVER

Mr. Harlan Holben, a graduate of Denver University in 1934 and a Colorado C.P.A., 1936, has been engaged as instructor in accounting.

A course in Budgetary Control will be offered during the winter quarter, by Ralph B. Mayo, C.P.A.

At a recent meeting of the Colorado Society of Certified Public Accountants a resolution addressed to the State Board of Accountancy was unanimously adopted by the Society recommending that the board accept a degree from the School of Commerce of a recognized university as the equivalent of one year's experience in qualifying applicants to take the examination. This would mean a requirement of two years of practical experience plus the college degree.

George A. Warfield, Dean of the School of Commerce of the University of Denver for the

past 23 years, has resigned and will be succeeded by Clem W. Collins, assistant dean. Although relieved of the active direction of the School, Dr. Warfield will continue as a member of the executive committee and professor of Economics.

Clem Collins, the new dean, is a certified public accountant and former manager of revenue of the city of Denver. He has been associated with the School of Commerce Faculty for the past ten years, and has been assistant dean for three years.

### UNIVERSITY OF ILLINOIS

Enrollment in accounting courses this fall is 2338. The Accountancy Club is again the largest and most active student organization on the campus, with a membership of over 400 and an average attendance at its biweekly meetings of about 250.

The members of the accounting staff are engaged in a study of the graduate offerings of the department with a view to enlarging the scope of the work offered to accommodate the students attracted by the announcement of the offering of a Ph.D. in Accountancy.

### UNIVERSITY OF IOWA

Professor H. H. Wade is on leave for the current year and will be on the staff of the New York office of Price, Waterhouse, and Company.

J. R. McCoy of Ohio State University has joined the staff as instructor in accounting.

Professor S. G. Winter was recently named one of the trustees of the Iowa Society of Certified Public Accountants and was also elected treasurer of the Association of Iowa Accountants.

### LOUISIANA STATE UNIVERSITY

Mr. Kenneth A. Dick, who has served as instructor in accounting since September has resigned to return to the University of Idaho. Mr. J. Royce Miles has been appointed instructor in accounting. The following are graduate assistants: R. L. Anderson, M. U. Broussard, R. M. Harris, H. E. Hawthorne, A. E. Hemming, W. D. Richins, J. R. Roane, Clarence Scheps.

New courses have been added in Secretarial Accounting and in the use of calculating and bookkeeping machines.

A series of lectures on accounting topics of current interest are being delivered during the year by members of the Louisiana Society of Certified Public Accountants.

UNIVERSITY OF MONTANA

Professor H. K. Snell is taking a year's leave of absence at the University of Southern California. He will do research work in the field of transportation in the Los Angeles area. His place will be filled by Dr. Jordan, formerly with Northwestern University. Miss Alice Berland is a new assistant in the fields of accounting and stenography.

Because of weaknesses in the fundamentals of mathematics, first year accounting students are being given a drill course in business arithmetic. The course is at present an elective.

UNIVERSITY OF OREGON

Dean H. V. Hoyt left the School of Business Administration July 1, and his place has been taken by Mr. Victor P. Morris.

New graduate assistants in the department are J. C. Goplerud and Howard E. Green.

The local chapter of Alpha Kappa Psi is making a retail survey of Eugene, Oregon.

STANFORD UNIVERSITY

Dean J. Hugh Jackson has been elected first

vice-president of the N.A.C.A. for the year 1936-37.

Beginning with the summer quarter of 1937 the Graduate School of Business Administration will go on a regular four quarter basis so that students entering the School may complete their program of work in six consecutive quarters of residence.

UNIVERSITY OF TEXAS

William A. Nielander, formerly of the Agricultural Adjustment Administration has been appointed associate professor of marketing. J. C. Gulley and J. E. Hodges have been appointed instructors in business administration.

WAYNE UNIVERSITY

Two men have been added to the staff as assistant professors of accounting: Edward G. Eriksen, who comes from the University of Minnesota, and B. F. McFaden, who was formerly with the Wilson Packing Company of Chicago.

There has been an increase of approximately thirty-three per cent in the enrollment in accounting courses this year.

# AMERICAN ACCOUNTING ASSOCIATION

*21st Annual Meeting  
Stevens Hotel, Chicago, Illinois  
December 28-29, 1936*

*First Session. 10:00 A.M., Monday, December 28*

CHAIRMAN: E. L. Kohler, President

TOPIC: Whither Accounting?

PAPER: "The Role of Accounting in the Future of Business," William Z. Ripley, Harvard University

*Second Session. 12:30 P.M., Monday, December 28*

Members' Luncheon

*Third Session. 2:00 P.M., Monday, December 28*

CHAIRMAN: Ralph C. Jones, Yale University

TOPIC: Roundtables on Accounting Instruction

Methods and Objectives of the First Course in Accounting, Ralph C. Jones, Yale University, Leader

Internal Control in Business in the Accounting Curriculum, J. Brooks Heckert, Ohio State University, Leader

Trends and Practices in Cost-Accounting Instruction, Wyman P. Fiske, Massachusetts Institute of Technology, Leader

Practical Problems for the Accounting Instructor, H. W. Bordner, Arthur Andersen & Co., Leader

*Fourth Session. 6:30 P.M., Monday, December 28*

Dinner and business meeting

Reports of officers and committees

Election of officers

*Fifth Session. 9:30 A.M., Tuesday, December 29*

(Joint meeting with American Economic Association)

CHAIRMAN: Stanley E. Howard, Princeton University

TOPIC: Concepts of Capital and Income

PAPERS:

"Reformulation of the Concepts of Capital and Income," Frank A. Fetter, Princeton University

"Concepts of Capital and Income Underlying Accounting," A.C. Littleton, University of Illinois

"The Concepts of Capital and Income as Related to the Regulation of Public Utilities," Dr. John Bauer, American Public Utilities Bureau

*Sixth Session. 12:30 P.M., Tuesday, December 29*

Luncheon for members of the American Accounting Association given by the Illinois Society of Certified Public Accountants

*Seventh Session. 2:00 P.M., Tuesday, December 29*

CHAIRMAN: Howard C. Greer, University of Chicago

TOPIC: Accounting Principles

PAPERS:

"A Critique of the Tentative Statement of Principles published by the Executive Committee of the American Accounting Association in 1936," C. Rufus Rorem, Rosenwald Foundation

"The Need for Accounting Principles," Carman G. Blough, Securities and Exchange Commission

"The Interest of the Investor in Accounting Principles," Paul L. Morrison, Sheridan, Farwell & Morrison, Inc.

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## CONTRIBUTORS OF ARTICLES

ANDREW BARR is assistant professor of accounting at Yale University.

J. G. BLOCKER, assistant professor of accounting at the University of Kansas, is chairman of the accounting department of that University. He recently served as cost accountant and auditor for the Kansas Emergency Relief Administration.

S. J. BROAD is a partner in the accounting firm of Peat, Marwick, Mitchell & Company, New York, and chairman of the special committee of the American Institute of Accountants on the revision of the pamphlet, "Verification of Financial Statements."

MONROE S. CARROLL, professor of accounting and finance at Baylor University, Waco, Texas, has developed the subject, *Accounting and Budgetary Control*, at the University of Chicago for his doctor's dissertation.

WILLIAM MORSE COLE is emeritus professor of accounting at Harvard Graduate School of Business Administration and the author of an accounting text which has been used many years in college courses.

EMMA CORSTVET (Mrs. K. N. Llewellyn), research assistant in community studies in the Yale Institute of Human Relations, continues in this issue with her findings relating to the existence of adequate accounting records in business enterprise.

WILLIAM T. CRANDELL, Ph.D. (University of Michigan), contributes a second article abstracted from his dissertation on National Income.

MERRILL B. DILLEY is chairman of the department of accounting, Drake University, Des Moines, Iowa.

JAMES L. DOHR, former president of A.A.U.I.A., is a member of the New York Bar, is associated with Greene & Hurd, attorneys, and is associate professor of accounting at Columbia University.

E. I. FJELD is assistant professor of accountancy at the College of the City of New York and in practice in New York as a certified public accountant. He is a doctor of philosophy from Columbia University.

IRA N. FRISBEE is associate professor of accounting in the College of Business Administration at the University of California at Los Angeles, and is co-author with John R. Rigglesman of *Business Statistics*.

PAUL M. GREEN, a member of the accounting faculty of the University of Illinois, has been on leave from that University since January 1, 1934 as head research accountant for the Federal Housing Administration.

HENRY R. HATFIELD is professor of accounting at the University of California. His name is known to all accountants.

STANLEY E. HOWARD is chairman of the Department of Economics and Social Institutions of Princeton University.

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Northwestern University School of Commerce.

ROY B. KESTER is professor of accounting at Columbia University. He has recently organized the "college of accountancy" within the School of Business—a three-year course of training for the practice of accountancy, following two years of liberal-arts work.

EDWARD J. KIRKHAM is an instructor in accounting at the University of Illinois.

HARRY L. KUNZE is in charge of the evening courses in accounting given at the Milwaukee Center by the Extension Division of the University of Wisconsin.

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RICHARD N. OWENS, professor of accounting and business administration, George Washington University, was formerly financial adviser on the steel industry in the Division of Review of N.R.A. He is joint author of *Accounting—Elementary Theory and Practice*.

W. A. PATON is professor of accounting at the University of Michigan and a member of the accounting firm of F. E. Ross & Company. He is editor of the most recent edition of the *Accountants' Handbook* and is director of research of the American Accounting Association.

GABRIEL A. D. PREINREICH is the author of *The Nature of Dividends*, his doctoral dissertation at Columbia University; he is also a practicing certified public accountant in New York.

C. RUFUS ROREM is associate director for medical services, Julius Rosenwald Fund, Chicago. He is the author of several books on the economic aspects of medical services and is chairman of the committee of the American Hospital Association which recently prepared a uniform system of hospital accounting and statistics.

T. H. SANDERS, professor of accounting at the Harvard Graduate School of Business Administration, has devoted much of his time during the last two years as a special adviser to the Securities and Exchange Commission.

J. S. SEIDMAN is a member of the firm of Seidman & Seidman, certified public accountants. He is chairman of the National Tax Committee of the Young Men's Council and associate director of the New York Chapter of the National Association of Cost Accountants.

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D. M. SHONTING, assistant professor of accounting at Ohio State University, also holds the position of treasurer of Capital University, Columbus, Ohio. He was formerly chief of Division of Accounts and Control in the Department of Finance of the State of Ohio.

FRANK P. SMITH is an instructor in economics at the University of Rochester.

WALTER STAUB is a member of the firm of Lybrand, Ross Bros. & Montgomery, New York.

JOHN C. TEEVAN is professor of commercial law at Northwestern University, Chicago. He is the author of two books of answers to C.P.A. law questions.

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ARTHUR H. WINAKOR is assistant director of the Bureau of Business Research at the University of Illinois.

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